

# Bank Holding Company Supervision Manual

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Division of Banking Supervision and Regulation

# Bank Holding Company Supervision Manual

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Prepared by:  
Division of Banking Supervision and Regulation  
Board of Governors of the Federal Reserve System

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Bank Holding Company Supervision Manual

Supplement 18—June 2000

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised supervisory guidance and instructions issued by the

Division of Banking Supervision and Regulation since the publication of the December 1999 supplement.

LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2090.7	2090.7	<p>This section on nonbank banks has been revised to reflect the amendment of section 4(f) of the Bank Holding Company Act (BHC Act) by section 107 of the Gramm-Leach-Bliley Act (GLB Act). Cross-marketing, growth, and certain activity limitations and other provisions were eliminated to allow bank holding companies to affiliate with securities firms and insurance companies. New section 4(f)(3) provides details on the general overdraft prohibitions for controlled subsidiary banks of grandfathered holding companies of nonbank banks (those existing on March 5, 1987) and on when certain overdrafts are permissible, particularly overdrafts involving financial activities or activities incidental thereto. This section also details what happens if a company fails to continue qualifying for the nonbank bank exemption.</p>
2128.06		<p>This new section pertains to retained interests arising from assets sold to a securitization vehicle that, in turn, issues bonds to investors. Supervisory concerns exist about the methods and models that are used to value these interests and the difficulties involved in managing the risk of such volatile assets.</p> <p>Generally accepted accounting principles (GAAP) require recognition of an immediate gain (or loss) on the sale of assets by recording its retained interest at fair value. The retained interest is valued using the present value of future cash flows in excess of any amounts needed to service the bonds and to cover credit losses and other fees.</p> <p>Bank supervisors of banking organizations expect retained interests to have documented and verifiable fair values, otherwise they should be charged off. Other supervisory concerns include (1) a failure to recognize and hold sufficient capital against recourse obligations generated by securitization, and (2) the absence of adequate risk-management systems that include effective policies and limits, independent procedures to measure and assess risk, strong internal controls, and an independent audit function. See SR-99-37.</p>
3000.0.3	3000.0.3	<p>The list in appendix 2, nonbanking activities approved by Board order, is revised to include two more activities that were approved by the Board under section 4(c)(8) of the BHC Act. These activities were approved before the passage of the GLB Act, which prohibits Board approval of any additional section 4(c)(8) activities. Accordingly, these are the last nonbanking activities to be approved under this section.</p>

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
3600.0	3600.0	The nonbanking activities permissible by Board order under section 4(a)(2); 4(c)(8); or, for BHCs that also are FHCs, 4(k)(1)(B) of the BHC Act are revised. This section of the manual incorporates the current 60-day notice procedure and GLB Act changes. The Board is prohibited from approving any new nonbanking activities by regulation or order under section 4(a)(2) or 4(c)(8). BHCs that are qualified as FHCs under section 4(j)(4), and operating in accordance with section 4(k)(4), may engage in new activities that are “financial in nature or incidental to such activity” or “complementary to a financial activity.”
3600.6		Operating a securities exchange is a new nonbank activity that was approved by Board order under section 4(c)(8) of the BHC Act. A BHC and a foreign banking organization (FBO) requested the Board’s approval to acquire, separately, interests in a group which intended to operate an electronic securities exchange, and thus engage in secondary trading of equity and equity-related securities. An office is to be located in the United States. See 2000 FRB 61.
3600.7		The new nonbanking activity of acting as a certification authority (CA) for digital signatures involves sending digitally signed encrypted messages, using a confidential private key. An FBO and several BHCs requested the Board’s approval to engage, through a joint venture, in acting as a rulemaking and coordinating body for a network of financial institutions acting as CAs. They would provide services designed to verify or authenticate the identity of customers conducting financial and nonfinancial transactions over the Internet and other “open” electronic networks. Digital certificates and digital signatures would involve using a pair of public/private keys to decrypt and confirm the sender’s electronic signature (referred to as issuing “digital certificates”). See 2000 FRB 56.
3900.0		This new section introduces, generally, FHCs and the GLB Act. It details conditions that must be met for a BHC to become a qualifying FHC. An FHC may engage, or acquire a company that engages in, authorized activities deemed to be “financial in nature” or any activity that is incidental to a financial activity or complementary to a financial activity engaged in by the FHC. Notice requirements for becoming an FHC, and for engaging in such activities, are discussed generally.
3901.0		This new section details what a written declaration must include for a BHC to qualify as a domestic FHC. Acquisition, control, and other requirements are discussed with respect to engaging in financial activities. Applicable notice procedures and other requirements to engage in financial activities and activities incidental thereto also are specified. Divestiture requirements are detailed with respect to impermissible activities that are acquired together with permissible activities. If the Federal Reserve has supervisory concerns, it may limit or restrict the conduct of new activities or future acquisitions, or take other action, if it finds that

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
		an FHC does not have the needed financial or managerial resources. See SR-00-01 and, in particular, Regulation Y at 12 C.F.R. 225.81–225.88.
3903.0		The qualification requirements for foreign banks to operate as FHCs and engage in activities that are financial in nature, or any activity that is incidental or complementary to a financial activity, are provided in this new section. This includes the “well-managed” and “well-capitalized” standards needed for certification as an FHC, as they pertain to <i>each</i> foreign bank, or to each company owning a foreign bank, operating in the United States and to each FBO. The process and requirements that apply when a foreign bank does not continue to satisfy the management and capital requirements are also discussed. See SR-00-01 and, especially, Regulation Y at 12 C.F.R. 225.91–225.94.
3905.0		Permissible activities of qualifying FHCs that are deemed under section 4(k)(4) of the GLB Act to be activities that are “financial in nature” and activities deemed to be incidental or complementary to a financial activity engaged in by the FHC are discussed in this new section. Included are activities authorized under section 4(c)(8) of the BHC Act that the Board has determined to be closely related to banking. See Regulation Y at 12 C.F.R. 225.28(b) and 225.86–225.89.
4060.3	4060.3	The risk-based capital measure section is revised to include the capital treatment for credit derivatives used to synthetically replicate collateralized loan obligations (CLOs). This guidance was developed jointly by the Federal Reserve and the Office of the Comptroller of the Currency. Credit derivatives allow an assumption or transfer of credit risk on a specified or “referenced” asset or pool of assets. CLOs represent asset-backed securities that are supported by various assets. The capital treatment for three synthetic CLO transactions is provided: (1) when the entire amount of the referenced portfolio is hedged, (2) when a high-quality senior risk position in the reference portfolio is retained, or (3) when a first-loss position is retained. Minimum conditions are specified for sponsoring institutions wishing to use the second type of transaction. See SR-99-32.

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## Supplement 17—December 1999

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised supervisory guidance and instructions issued by the

Division of Banking Supervision and Regulation since the publication of the June 1999 supplement.

### LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2010.2.2 2010.2.3 2010.2.4 2010.10	2010.2.2 2010.2.3 2010.2.4 2010.10	The Federal Reserve has expressed concerns about the possible weakening of compliance with loan-underwriting standards, policies, and internal controls and loan-review procedures. A reduction of resources devoted to loan underwriting as a result of an undue reliance on continued favorable economic conditions and easy access to financial markets is also cause for concern. Banking organizations should exercise caution since such prosperity may not continue. Adherence to preestablished standards, policies, and procedures should provide protections from concentrations of weakening credit risk. The use of meaningful stress tests is encouraged in the lending-decision process to validate a borrower's financial capacity to repay (including alternative sources of repayment) according to the repayment terms over the short and long terms. Stress testing should be most beneficial to banking organizations as a safeguard against increased losses due to possible economic downturns. See SR-99-23. Appropriate inspection objectives and procedures are included.
2010.7	2010.7	This section has been revised to include consideration of evolving supervisory guidance that emphasizes the need for applying reserving practices that are balanced, yet conservative, with respect to the maintenance of an allowance for loan and lease losses. A discussion of accounting guidance is provided with respect to the Financial Accounting Standards Board's Statements No. 5 and 114. See SR-99-13 and SR-99-22.
2124.01		This section provides the Federal Reserve System's supervisory program for the risk-focused supervision of and inspection framework for large, complex banking organizations (LCBOs). The program endorses the concept of conducting, when appropriate, a series of targeted inspections/examinations during a supervisory cycle, focusing on a single activity, business line, and legal entity. The program centers on avoidance of duplication and continued close coordination and cooperation with federal and state supervisors. The findings and conclusions of such supervisors are incorporated into an overall assessment of the consolidated banking organization or banking group. The framework specifies six key steps in the risk-focused supervision of LCBOs. See SR-97-24 and its handbook, <i>Framework for Risk-Focused Supervision of Large,</i>



New Section Number	Previous Section Number	Description of the Change
		<i>Complex Institutions</i> , and also the handbook’s appendixes. Previously issued risk-focused inspection/examination guidelines and procedures are considered and listed in an appendix. See also section 2124.04 and SR-99-15, which sets forth the continued, ongoing, supervisory approach for LCBOs.
2124.04		The Federal Reserve System’s ongoing risk-focused supervision and monitoring program for LCBOs is set forth in this section. The program should be conducted at least quarterly. The guidance builds upon the existing risk-focused supervisory program, providing more specific guidance. Concerns are noted for certain environmental factors that could initiate swift and dramatic changes in the risk profiles of LCBOs, resulting in rapid changes in their financial condition. The ongoing program portrays and uses a continuous portfolio approach to supervision—the continuous assessment and evaluation of informational resources and banking practices across a group of institutions with similar business lines, characteristics, and risk profiles. Emphasis is placed on an organization’s management of internal systems and controls, including rating systems, and the Federal Reserve System’s use of a central point of contact and dedicated supervisory teams for each LCBO. See SR-99-15.
2126.3		This section sets forth the Federal Reserve System’s supervisory guidance for examiners and supervisory staff on evaluating and monitoring counterparty risk-management functions and systems. Transaction testing is to be used on those activities, business lines, and products experiencing significant growth, above-normal profitability, or large future potential exposures. Particular attention should be focused on (1) the standards, methodologies, and techniques used to measure and control counterparty-credit-risk exposures; (2) the use and management of credit enhancements to mitigate counterparty credit risks; and (3) the use of risk limits and monitoring systems that are established to set meaningful limits on counterparty credit risk and to alert management when credit-risk exposures exceed their established limits. See SR-99-3.
2190.05		This section discusses the March 1999 interagency supervisory guidance on subprime lending. Banking organizations engaging in this lending must recognize the additional risks inherent in the activity, and must determine whether those risks are acceptable and manageable considering their staff, financial condition, size, and level of capital support. Subprime lending necessitates strong risk-management practices; board-approved policies and procedures; and internal controls that appropriately identify, measure, monitor, and control the risks. Bank holding companies should consider this guidance as they supervise their banking and non-bank subsidiaries. See SR-99-6.
3130.4.4.2	3130.4.4.2 3290.0	This revision incorporates former Board authorizations for futures commission merchants and commodity trading advisers to provide nonbanking advisory services.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
3320.0	3320.0	This revised section includes more recent Board order references involving check-guarantee and check-verification services. See 1999 FRB 582.
4060.7		<p>Large and other complex banking organizations (BOs) must maintain strong internal processes to ensure that their capital is fully sufficient to support the underlying risks inherent in their activities and environment, as well as their need to comply with minimum regulatory capital adequacy standards, a critical element of a BO's safety and soundness. Due to the growing scope and complexity of business activities and ongoing financial innovation, simple ratios, including risk-based capital ratios, no longer suffice in assessing the overall capital adequacy of many BOs.</p> <p>Examiners are to evaluate internal capital-management processes to judge whether they meaningfully tie the identification, monitoring, and evaluation of risk to the determination of the BO's capital needs. Fundamental elements of a sound and comprehensive internal analysis of capital adequacy are stated along with the encompassing key areas of risk.</p> <p>BOs are encouraged to strengthen their risk-measurement capabilities and to integrate them more fully when evaluating their own capital adequacy. Some of the cited practices extend beyond those currently followed. Examiners should expect these BOs to make steady and meaningful progress toward initiating a comprehensive internal process for assessing capital adequacy in relation to risk, rather than immediate and full implementation. Examiners should expect those BOs involved in complex securitizations or other similar transfers of risk to have in place or immediately implement a comprehensive internal capital analysis process that fully reflects all risks. See SR-99-18.</p>
4070.3		<p>Guidance is provided on the use and assignment of supervisory ratings involving the ongoing risk-focused supervision of BOs. Supervisory ratings should be revised when there is strong evidence of a change in the financial condition or risk profile of a BO. Ratings are viewed as a continuum, not as a point-in-time assessment.</p> <p>When one supervisory rating component (for example, CAMELS, BOPEC, or other rating) is changed, the other components, and the composite and management ratings, must also be reaffirmed or revised. Rating changes are to be communicated to the board of directors of the affected BO (or to the senior U.S. management official) and to the appropriate state and federal supervisory agencies.</p> <p>Federal Reserve System staff are to review all inspections and examinations that are conducted by state supervisory agencies under the Alternate Examination Program. Any ratings or changes assigned by the Federal Reserve should be noted separately. See SR-99-17.</p>

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### LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2010.12		This section provides new examiner supervisory guidance with respect to fees that are derived from investments of fiduciary assets in mutual funds and concerns associated with any potential conflicts of interests. The section emphasizes that a due-diligence review is needed with regard to the acceptance of such fees. The review should consist of (1) a reasoned legal opinion, (2) established policies and procedures, and (3) regular and ongoing analyses supporting investment decisions. Inspection objectives and procedures are included with the guidance.
2020.1.1.8	2020.1.1.8	This intercompany transactions section is revised to incorporate the staff interpretation of January 21, 1999, for section 23A(b)(7)(D) of the Federal Reserve Act and the calculation of the quantitative limits for loans and extensions of credit that are secured by shares issued by an affiliate.
2070.0	2070.0	This consolidated taxes section is revised to incorporate an inter-agency policy statement on tax-allocation agreements for banking organizations and savings associations. The policy statement, effective November 23, 1998, stresses that an institution and its parent company should conduct intercorporate tax settlements in a manner that is no less favorable to a subsidiary than if it was a separate taxpayer. Topics such as the composition of the consolidated written tax sharing agreements, measurement of current and deferred income taxes, tax payments to the parent company, tax refunds from the parent company, and income tax forgiveness transactions are discussed. The inspection objectives and procedures also are revised. See SR-98-38.
2128.0	2128.0	This slightly revised section consists of general information on structured notes. The section was amended to provide references to SR-97-21, SR-95-17, and various sections of the <i>Trading and Capital-Markets Activities Manual</i> for more detailed guidance.
2231.0	2231.0	A footnote is added to this section on real estate appraisals and evaluations to accommodate the revision of section 225.63 of Regulation Y, effective December 28, 1998, involving the appraisal standards for federally related transactions. The amendment permits BHC subsidiaries to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that satisfy the Board's appraisal requirements.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2241.0		This new section on retail credit classification discusses new expanded supervisory classification guidance for retail credit loans, the Uniform Retail-Credit Classification and Account-Management Policy. The policy focuses on classification of past-due loans, when loans should be charged off, and fraudulent loan treatment. Other supervisory issues addressed include well-secured loans; partial loan payments; loan extensions, deferrals, and re-aging; and examination considerations. See SR-99-5.
2250.0	2250.0	The domestic and other reports section is revised to eliminate the summaries of specific reports and to address only reporting issues. The current reports and instructions are now found on the Board's Internet public web site.
3000.0.3, appendix 2	3000.0.3, appendix 2	The list of nonbanking activities approved only by Board order was updated for private limited partnerships. Manual section references also were added for new nonbanking activities approved only by Board order.
3084.0	3600.15.3 3600.15.4	This is a new section that involves engaging in asset-management, asset-servicing, and collection under contract with a third party as currently found in section 225.28(b)(2)(vi) of Regulation Y. A bank holding company may engage under contract with a third party in such nonbanking activities, but only with respect to the types of assets that an insured depository institution can originate and own. Historical examples from Board orders are provided for such activities, reflecting how they originated and illustrating the factors that led to their incorporation in Regulation Y.
3104.0	3600.15.5	This new nonbanking section discusses the Regulation Y provision (section 225.28(b)(2)(vii)) and limitations for engaging in the acquisition of debt in default. A previous Board order is summarized and included in this section to illustrate how the nonbanking activity originated.
3130.1.4	3130.1.4	This revised section on investment or financial advisers includes a new reference to the new Uniform Interagency Trust Rating System. See SR-98-37.
3202.0	3200.0.2 3600.15.1	This new nonbanking section discusses employee benefits consulting services authorized by section 225.28(b)(9)(ii) of Regulation Y. A summary of a Board order approving these activities is provided.
3204.0	3200.0.2 3600.15.1.1	This new nonbanking section separately discusses career counseling services (including to whom they may be provided), as currently provided for in section 225.28(b)(9)(iii) of Regulation Y. A Board order summary is provided to illustrate how the activity originated and how it was incorporated within Regulation Y.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
3260.0	3260.0	This nonbanking section on investment transactions as principal has been revised to include a discussion on the permissibility of engaging in buying and selling bullion and related activities for a bank holding company's own account or for the account of others (see Regulation Y, section 225.28(b)(8)(iii)). It also discusses the permissibility of bank holding companies' investing in derivatives on financial and nonfinancial commodities, subject to the specified three conditions.
3270.0.2	3270.0.2	This real estate and personal property appraising section has been revised to include a footnote on the revised appraisal standards for federally related transactions involving the underwriting and dealing of mortgage-backed securities. The regulatory amendment (section 225.63 of Regulation Y) permits section 20 nonbanking subsidiaries to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by adequate appraisals meeting those standards.
3600.8		<p>This is a new nonbanking section on private limited investment partnerships summarizing several Board orders that authorized this activity. One Board order involved the private placement of limited partnership interests in a group of partnerships. A wholly owned subsidiary served as the sole general partner. The other partnership interests were to be sold to institutional investors. The partnerships would invest in limited amounts of debt and equity securities. Debt securities issued by the partnerships could not be privately placed without Federal Reserve approval. See 1994 FRB 736.</p> <p>A subsequent Board order is summarized that authorized an asset-management subsidiary to act as the general partner for each limited partnership. The partnerships would invest in a variety of commodity and exchange-traded and over-the-counter instruments. One or more of the partnerships could invest its assets in commodity pools, as a registered commodity pool operator. See 1995 FRB 1128.</p> <p>More recent Board orders are cited for private limited partnerships investing solely in permissible investments for a BHC. For example, see 1999 FRB 209, 1998 FRB 852, and 1998 FRB 361.</p>
3600.13	3600.13	This nonbanking section is revised to indicate that the Board order authorizing the activities of a commodity pool operator (that invests solely in investments that a BHC is permitted to make directly) also involved control of a private limited partnership.
3600.25		This is a new nonbanking section involving a Board order authorizing a bank holding company to engage in certain government services (for example, providing postage, vehicle registration and license plates, public transportation tickets, and notary public services) that had not previously received Board approval.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
3600.28		This new nonbanking section summarizes the Board’s order authorizing the development of broader marketing plans and advertising and sales literature materials for mutual funds. The summary discusses the delegation of responsibility of the distribution, advertising, and sales of the mutual funds to an independent distributor. It explores the various control issues, including management interlocks.
4060.3.2.2	4060.3.2.2	The risk-based capital adequacy section has been revised for investments in mutual funds. When risk weighting is applied to a mutual fund on the basis of the risk categories of the fund’s assets, and the sum of the investment limits for all asset categories (as described in the funds prospectus) exceeds 100 percent, risk weights must be assigned based on the assumption that the fund invests the largest possible amount of its assets in the highest risk-weighted categories. The mutual fund’s total risk weight must be at least 20 percent. The risk weighting will not increase from the prudent use of hedging to reduce risk. When a fund engages in speculative activities, or when any other characteristics are inconsistent with the preferential risk weighting of the fund’s assets, the fund’s holdings are to be assigned to the 100 percent risk category.
4060.3.5.2.3	4060.3.5.2.3	<p>Loans to residential builders will be considered prudently underwritten only if sufficient documentation provides evidence of legally binding written sales contracts and commitments for permanent financing.</p> <p>When a first and junior lien(s) on a residential property are held (and no other party holds an intervening lien), the transaction is treated as a single loan secured by a first lien when determining the loan-to-value ratio and assigning a risk weight.</p>

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<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2010.2.2		This new subsection has been added to convey supervisory guidance to examiners for evaluating the adequacy of lending standards for commercial loans; it consists of formal credit policies; formal credit-staff transaction approvals; loan-approval documentation, including the use of forward-looking financial analysis tools; and the use of management information systems that support the loan-approval process. Examiners are to determine whether adequate internal oversight exists and whether management has timely and accurate information. See SR-98-18. Inspection objectives and procedures are provided.
2010.11		<p>This section provides examiners with guidance for reviewing private-banking activities. A functional review subsection is provided that contains basic “know-your-customer” principles.</p> <p>Examiners are to review the functional components of private banking across all production lines. The functional components consist of supervision and organization, risk management, operational controls, fiduciary standards, management information systems, audit, compliance, and the financial condition/business profile. See SR-97-19. Inspection objectives and procedures are provided.</p>
2060.05		<p>This new section discusses the internal audit function and its outsourcing. The section sets forth an interagency supervisory policy statement that focuses on issues dealing with organizational structure, internal audit management, staff and quality control, audit scope, and the communication of findings directly to the board of directors. Examiner guidance is provided for assessing the quality and effectiveness of an organization’s internal audit function and its management.</p> <p>Inspection considerations with regard to outsourcing the internal audit function are specified. Supervisory guidance is provided for managing an outsourced internal audit function. See SR-97-35. Inspection objectives and procedures are provided.</p>

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2122.0		<p>Certain essential elements of internal rating systems are necessary to support sophisticated credit-risk management. This section conveys supervisory guidance for financial institution supervisors and their examiners that needs to be emphasized as being important to the development and implementation of effective internal credit-rating systems. Such systems play critical roles in the credit-risk-management process, particularly at large sound banking institutions. Large banking institutions are to have strong risk-rating systems that take into account gradations in risk. Such systems should consider (1) the overall composition of portfolios in originating new loans, (2) the assessing of overall portfolio risks and concentrations of credit, and (3) the prompt reporting of risk profiles to directors and management. See SR-98-25, which expands upon issues raised in SR-98-18 (Lending Standards for Commercial Loans). See also section 2010.2.2.</p> <p>Examiners should specifically evaluate the adequacy of internal credit-risk-rating systems, including ongoing development efforts, when assessing both asset quality and the overall strength of risk management at large institutions. In so doing, examiners should be cognizant that an internal risk-identification and -monitoring system should be consistent with the nature, size, and complexity of the banking organization's activities. Inspection objectives and procedures are provided.</p>
2124.1		<p>This section sets forth risk-focused supervisory guidance to be applied when assessing the use of information technology, giving appropriate recognition to the characteristics, size, and business activities of the organization. The role of examiners in the risk-focused supervision of information technology is summarized within four primary inspection procedures (see subsection 2124.1.2). It provides a framework for evaluating information technology, consisting of information technology elements—the management processes, architecture, integrity, security, and availability of information to end-users. See SR-98-9. Inspection objectives and procedures are provided.</p>
2126.0.2 (footnote 3)	2126.0.2 (footnote 3)	<p>These sections have been amended to accommodate the April 1998 FFIEC Statement on Investment Securities and End-User Derivatives Activities, effective May 25, 1998. This statement replaced the 1992 Supervisory Policy Statement on Securities Activities. References to the 1992 minimum requirements for high-risk mortgage securities have been removed.</p>
2126.0.4.4 (footnote 6)	2126.0.4.4 (footnote 6)	
2126.0.8.1	2126.0.8.1	
2126.0.8.2 (footnote 10 deleted)	2126.0.8.2	
2130.0.13	2130.0.13	
2130.0.17	2130.0.17	
3070.0.5.1.1.2	3070.0.5.1.1.2	
3070.0.13	3070.0.13	

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2126.1		<p>This new section consists of the April 23, 1998, FFIEC Statement on Investment Securities and End-User Derivatives Activities, effective May 25, 1998. The supervisory guidance applies to state member banks and Edge corporations. The basic principles also apply to bank holding companies, which should manage and control risk exposures on a consolidated basis, giving recognition to the legal distinctions and potential obstacles to cash movements among subsidiaries.</p> <p>The statement's principles set forth sound risk-management practices that are relevant to most portfolio-management endeavors. Instruments held for end-user reasons are considered, taking into consideration a variety of factors such as management's ability to manage and measure risk within an institution's holdings and the impact of those holdings on aggregate portfolio risk.</p> <p>The statement focuses on managing the market, credit, liquidity, operational, and legal risks of investment and end-user activities. When managing the interest-rate-risk component of market risk, institutions are informed of the merits of developing internal policies that specify the type of preacquisition analysis (stress testing) that is consistent with the scope, sophistication, and complexity of their investment securities and end-user derivative holdings.</p> <p>Institutions are advised to periodically monitor the price sensitivity of their portfolios, ensuring that they meet established limits of the board of directors. Institutions are further advised to fully assess the creditworthiness of their counterparties, including brokers and issuers. Institutions are to take proper account of the liquidity of the instruments they hold. See SR-98-12. The principles set forth within the interagency policy statement are generally those set forth in SR-95-17. See section 2126.0.</p>
2129.05		<p>This section sets forth supervisory guidance that identifies the more important risks associated with the more common types of secondary-market activities. The guidance discusses sound practices along with the special considerations financial institution supervisors should take into consideration when assessing the risk-management systems for secondary-market activities.</p> <p>A fundamental principle advanced by this guidance is that banking institutions should explicitly incorporate the full range of risks of their secondary-market credit activities into their overall risk-management systems. In particular, supervisors and examiners are to determine whether institutions are recognizing the risks of secondary-market credit activities by (1) adequately identifying, quantifying, and monitoring these risks; (2) clearly communicating the extent and depth of these risks in reports to senior management and the board of directors and in their regulatory reports; (3) conducting ongoing stress testing to identify</p>

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2129.05 continued		<p>potential losses and liquidity needs under adverse circumstances; and (4) setting adequate minimum internal standards for allowances or liabilities for losses, capital, and contingency funding. Incorporating secondary-market credit activities into a banking organization's risk-management systems and internal capital-adequacy allocations is particularly important since the current regulatory capital rules do not fully capture the economic substance of the risk exposures arising from many of these activities.</p> <p>Many secondary-market credit activities involve new and compounded dimensions of reputational, operational, and liquidity risks. Failure to understand adequately the risks inherent in secondary-market credit activities and to incorporate them into risk-management systems and internal capital allocations may constitute an unsafe and unsound banking practice. The risk-management systems used should include the identification, measurement, and monitoring of these risks as well as an appropriate methodology for the internal allocation of capital and reserves. See SR-97-21. Inspection objectives and procedures are provided.</p>
2140.0.1 2140.0.3.5 (footnote 2 deleted) 2140.0.3.7 3700.8	2140.0.1 2140.0.3.5  2140.0.3.7 3700.8	<p>These subsections have been revised to reflect changes resulting from the revision of the Board's Regulation T and, in some cases, the enactment of the National Securities Markets Improvement Act of 1996. Regulation T no longer determines whether specific types (or levels of collateral) are acceptable for securities borrowing and lending by broker-dealers.</p>
2187.0 (footnote 1) 2187.0.2.1 (title and footnote 2) 2187.0.2.2 (footnote 4)	2187.0 (footnote 1) 2187.0.2.1 (footnote 2) 2187.0.2.2 (now footnote 3)	<p>These subsections have been revised to reflect the merging of the Board's Regulation G into its Regulation U (which resulted in the elimination of Regulation G). The subsections have also been revised, as appropriate, to include the Board's adoption of amendments to Regulations U (effective April 1, 1998) and T (effective July 1, 1998).</p>
2187.0.4 2187.0.7 2187.0.8	2187.0.4 2187.0.7 2187.0.8	
2190.0.5 2190.0.5.1	2190.0.5 2190.0.5.1	<p>These subsections have been revised to reflect a brief summary of the April 23, 1998, FFIEC Statement on Investment Securities and End-User Derivatives Activities that replaced the January 1992 FFIEC Policy Statement on Securities Activities.</p>
3000.0.3, appendix 2	3000.0.3, appendix 2	<p>The list of nonbanking activities approved by Board order has been revised to include title agency insurance activities.</p>

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
3070.0.6.7	3070.0.6.7	This section was revised for the August 4, 1998, change in the capital adequacy standards for bank holding companies. The Regulation Y change increased the amount of servicing assets, along with purchased credit-card relationships (PCCRs), that are includable in regulatory capital from 50 percent to 100 percent of tier 1 capital. Servicing assets consist of the aggregate amount of mortgage-servicing assets (MSAs) and the amount of nonmortgage-servicing assets (NMSAs). The amendment includes a further sublimit of 25 percent of tier 1 capital to the aggregate amount of NMSAs and PCCRs, and subjects the valuation of MSAs, NMSAs, and PCCRs to a 10 percent discount. The final rule was effective on October 1, 1998.
3165.1	3600.12.3	This section discusses the current Regulation Y authorization for bank holding companies to engage in printing and selling MICR-encoded items as a support-services nonbanking activity.
3210.0	3210.0	These sections were revised to reflect the incorporation of consumer payment instruments, without any limit as to the face amount, into the April 21, 1997, revision of Regulation Y, section 225.28(b)(13).
3210.1	3600.12	
3073.0.1	3600.16.1	These sections or subsections were revised and/or relocated based on the restructuring of the April 1997 revision of Regulation Y.
3105.0	3600.14	
3107.0	3600.28	
3130.3.6	3600.16.2	
3160.5	3600.31	
3230.5	3600.7.1	
3230.6	3600.8	
3251.0	3600.13.1– 3600.13.12, 3600.13.14	This former section was relocated since certain futures commission merchant (FCM) nonbanking activities that were previously approved by Board order have been incorporated into Regulation Y, effective April 21, 1997. These subsections provide brief historical summaries of FCM Board decisions that may have resulted in their incorporation into Regulation Y. Former regulatory cites have either been deleted or updated.
3255.0		This new section focuses on agency transactional services to customers with respect to swaps and similar transactions as specified in section 225.28(b)(7)(v) of Regulation Y. This authority includes any derivative or foreign-exchange transaction that the bank holding company is permitted to conduct for its own account. The relocated former sections comprise Board order decisions that involved the brokering of options on various securities, bullion, and foreign exchange. Such nonbanking activities were incorporated into Regulation Y, effective April 1997.
3255.0.1	3600.6.1	
3255.0.2	3600.6.2	
3255.0.3	3600.6.3	

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
3260.0		This new section is for nonbanking activities involving investment transactions as principal. The section discusses the authority granted under Regulation Y, section 225.28(b)(8)(ii). Such proprietary trading was added to the regulation to clarify the permissibility of the nonbanking activity as a separate business activity.
3260.0.3.1	3600.6.4	Before the inclusion of such transactions into the regulation, certain activities had been previously approved by Board order. The section provides, as historical examples, summaries of those decisions, giving the reader the opportunity to understand why certain activities were incorporated into Regulation Y.
3260.0.3.3	3600.6.5	
3260.0.3.2	3600.6.6	
3260.0.3.4	3600.7.2	
3260.0.3.5	3600.25	
3260.0.3.6	3600.3	
	3600.4	Sections deleted.
	3600.6	
	3600.7	
	3600.10	
4060.3	4060.3	<p>The section is revised for the new August 4, 1998, regulatory capital treatment (risk-based measure) of servicing assets for mortgage assets and financial assets other than mortgages with respect to bank holding companies. The Regulation Y appendix change (effective October 1, 1998) increased the amount of servicing assets, along with purchased credit-card relationships (PCCRs), that are includable in regulatory capital from 50 percent to 100 percent of tier 1 capital. Servicing assets consist of the aggregate amount of mortgage-servicing assets (MSAs) and the amount of nonmortgage-servicing assets (NMSAs). The amendment applies a further sublimit of 25 percent of tier 1 capital to the aggregate amount of NMSAs and PCCRs, and also subjects the valuation of MSAs, NMSAs, and PCCRs to a 10 percent discount.</p> <p>The section is also revised for the Board's August 25, 1998, adoption of capital rule changes that became effective October 1, 1998. Bank holding companies that hold equity securities are permitted to include up to 45 percent of the pretax net unrealized holding gains on available-for-sale equity securities with readily determinable fair values in supplementary capital (tier 2 capital).</p> <p>See the rule for any limitations or precautions pertaining to these amendments.</p>

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
4060.4	4060.4	<p>This section has been revised for the May 29, 1998, amendment of the tier 1 leverage capital standard for bank holding companies (BHCs). The rule change (effective June 30, 1998) simplifies the Board's leverage capital standards for BHCs and incorporates the market-risk capital rule into the leverage standard. The revised rule set a minimum ratio of tier 1 capital to total assets (leverage ratio) of 3 percent for BHCs that are either rated composite "1" under the BOPEC rating system or have implemented the Board's risk-based capital market-risk measure. The minimum ratio for all other BHCs is 4.0 percent. BHCs are expected to maintain higher-than-minimum capital ratios if they have supervisory, financial, operational, or managerial weaknesses, or if they are anticipating or experiencing significant growth.</p> <p>The section is also revised for the August 4, 1998, change in the capital adequacy standards (tier 1 leverage measure) for bank holding companies, whereby the amount of servicing assets (mortgage-servicing assets and nonmortgage-servicing assets), along with purchased credit-card relationships (PCCRs), includable in regulatory capital, in the aggregate, increased from 50 percent to 100 percent of tier 1 capital.</p> <p>See the rule for any respective limitations regarding these amendments.</p>

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Bank Holding Company Supervision Manual

Supplement 14—June 1998

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised supervisory instructions issued by the Division of Banking Supervision and Regulation since the publication of the December 1997 supplement. Beginning with this supplement, more sublevel topics are included within the chapter tables of contents.

LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2090.2	2090.2	This section has been revised to reflect the change from a one-bank to a small bank holding company policy statement that the Board included in Regulation Y, which was effective in April 1997. Small BHCs whose subsidiary banks are well managed and well capitalized and whose acquisition proposals result in parent company debt-to-equity of less than 1.0 to 1 are eligible for streamlined application processing. Those companies can pay dividends under certain conditions. Acquisition proposals involving higher parent company leverage or a bank in less-than-satisfactory condition can be subject to a focused review of the parent-level debt-servicing ability or any other issue. BHCs are expected to reach a debt-to-equity ratio of .30 to 1 or less within 12 years after the incurrence of the acquisition debt.
3000.0.3, appendix 2	3000.0.3, appendix 2	This listing of Board approvals of nonbanking activities by order under section 4(c)(8) of the BHC Act has been substantially reduced due to the nonbanking activities that have been included in the Regulation Y “laundry list” (section 225.28(b)), effective on April 21, 1997.
3130.0		This general financial and investment advisory section provides a discussion for the subsequent advisory activities sections that are based on section 225.28(b)(6) of Regulation Y. The rule permits bank holding companies and their subsidiaries to engage in financial and investment advisory activities without restriction. BHCs can engage in any combination of permissible activities. BHCs may provide financial and investment advice (including discretionary investment advice) jointly with permissible agency transactional services, investment or trading transactions as principal, or any other listed activity. The regulation clarifies that the examples of permissible financial and investment advisory activities are illustrative rather than exclusive. Inspection objectives and procedures are provided that apply generally to all such activities.
3130.1	3130.1 3130.3	This financial and investment advisory activities section has been revised to include the changes in Regulation Y (section 225.28(b)(6)) that became effective in April 1997. The rule change grouped such activities together and broadly permits acting as an investment or financial adviser to any person, without restriction. The Board’s investment advisory interpretation (section 225.125 of Regu-

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
3130.1 continued	3130.1 3130.3 continued	lation Y) is discussed. Ownership, lending, and name restrictions were lessened. A detailed inspection checklist is provided for the examiner's review of financial and investment advisory activities.
3130.3	3130.2 3130.4 3130.6 3600.11	Advice in connection with organizational structurings, financing transactions, financial-feasibility studies, and valuation services is discussed in this section. It also includes inspection guidance on real estate investment trusts and on providing financial advice to foreign governments with respect to issuing their securities.
3130.4	3130.5 3130.7 3260.0 3600.18	This section discusses transactions in foreign exchange, structuring and arranging for swaps (including currency swaps), and similar transactions, commodities (including nonfinancial commodities), and forward contracts, options, futures, and options on a future, and similar instruments.
3130.5	3300.0	The consumer financial counseling section has been revised for the April 1997 Regulation Y changes that combined the activity with other financial and investment advisory activities. Regulation Y removed restrictions from promoting specific products and from obtaining or disclosing confidential customer information without the customer's consent.
3130.6	3310.0	Tax-planning and tax-preparation services are now included with financial and investment advisory activities. The section reflects the Board's removal of restrictions as indicated above for section 3130.5.
3200.0	3200.0	This management consulting services section has been revised to indicate that bank holding companies may (1) provide management consulting services regarding financial, economic, accounting, or audit matters to any company, and (2) derive up to 30 percent of their management consulting revenue from management consulting services provided to any customer on any matter. See Regulation Y, section 225.28(b)(9). Management consulting services and counseling activities were combined within this Regulation Y provision.
3230.0 3230.05 3230.1 3230.2 3230.3	3230.0 3230.1 3230.2 3230.3	These securities brokerage sections have been revised and updated for the Regulation Y changes. As discussed in sections 3230.0 and 3230.05, the rule no longer distinguishes between discount and full-service brokerage. Further, certain disclosure requirements were deleted from the rules. They remain, however, in Board and interagency policy statements. Also, for subsection 3230.0.3, outdated information pertaining to Regulations G, T, or U was deleted due to the Board's amendment of these regulations, effective April 1, 1998. (See 1998 FRB 197).
3240.0	3240.0	The Regulation Y cites for underwriting and dealing in U.S. obligations, municipal securities, and money market instruments have been revised.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
3250.0	3250.0	This futures commission merchant section has been revised to incorporate a risk-focused inspection approach as well as the Board's changes to Regulation Y. (See SR-97-33.) The section includes revised inspection objectives and procedures and an updated examiner inspection checklist. The listing of laws, regulations, interpretations, and Board orders has been updated.
3500.0	3500.0	The tie-in arrangements section has been revised to reflect the Board's decision (1) to rescind the regulatory extension of bank anti-tying rules to BHCs and their nonbank subsidiaries under section 106 of the BHC Act Amendments; (2) to retain the limited prohibition on tying arrangements involving electronic benefit transfer services; (3) to treat interaffiliate tying arrangements the same as intrabank tying arrangements so that a tying arrangement is permissible if the tied product is a loan, discount, deposit, or trust service; and (4) to extend the regulatory extension of the "traditional bank product" exception to reciprocity arrangements. (See also the subsections beginning at 3070.0.7.4.)
3600.8	3600.8	The Regulation Y cites have been updated. Due to amendments effective April 1, 1998, outdated Regulation T information was deleted.
5000.0.3 5000.0.4.1 5000.0.4.5	5000.0.3 5000.0.4.1	Starting at 5000.0.4.1, see the references to the Board's November 3, 1997, "Risk-Focused Supervision Policy for Small Shell Bank Holding Companies" (S-2587) that became effective on November 30, 1997. (See SR-97-27.) The policy reflects the supervision and inspection program for small shell bank holding companies (SSBHCs) having less than \$1 billion in consolidated assets. The policy amended the inspection scope and frequency requirements of SR-85-28, "Examination Frequency and Communicating with Directors." A risk assessment of each SSBHC and appropriate supervision strategy must be completed once each "supervisory cycle." The supervisory cycle is determined by the examination frequency that is mandated for the lead subsidiary bank.
	3130.2 3130.7 3260.0 3300.0 3310.0 3600.2 3600.11 3600.18 3600.20 4060.8	These sections have been deleted from the manual.

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# Bank Holding Company Supervision Manual

## Supplement 13—December 1997

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised super-

visory instructions issued by the Division of Banking Supervision and Regulation since the publication of the June 1997 supplement.

### LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2010.10 2060.0 2060.1 2060.2 2060.3 2060.4	2060.6 2060.0 2060.1 2060.2 2060.3 2060.4	These sections were revised to include limited changes to management information systems (MIS) inspection guidelines and procedures developed by a designated (MIS) Federal Reserve System task force.
2090.0	2090.0	This section on control has been revised to reflect the repeal of section 2(g)(3) of the BHC Act and to provide current definitions of “company,” “company covered in 1970,” and “acting through others” under the Bank Holding Company Act or the 1970 amendments. Most of the changes resulted from passage of the Economic Growth and Regulatory Paperwork Reduction Act of 1996.
2090.05		This section on qualified family partnerships describes a new class of companies consisting of general or limited partnerships that are exempt from the definition of company in the BHC Act, and thus are not subject to many of the provisions of the act if certain conditions are met.
	2270.0	This section on criminal referral information is obsolete. See the <i>Suspicious Activity Report Manual</i> (July 1996) and the <i>Bank Secrecy Act Examination Manual</i> (September 1997).
3000.0, appendix 1	3000.0, appendix 1	This appendix has been updated to reflect nonbanking activities added to section 225.28(b) of Regulation Y (the “laundry list”), effective April 21, 1997.
3110.0	3110.0	This section is revised to reflect the April 1997 Regulation Y changes for owning, controlling, and operating nonbank depository institutions (industrial banking—the institutions are not banks) and savings associations.
3111.0	3185.0	This section has been revised to include more current Board orders on the owning, controlling, or operation of a savings association.
3140.0	3140.0	The personal and real property leasing section was revised for the April 1997 changes to Regulation Y. The changes consisted of (1) the removal of numerous restrictions in order to permit greater flexibility in acquiring leasable property in quantity and to sell or re-lease property and (2) clarifications on requirements for a nonoperating lease, especially automobiles.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
3150.0	3150.0	The community development activities section has been updated with Board orders and interpretations, as well as for the April 1997 inclusion of community development advisory and related services into Regulation Y.
3160.0	3160.0	This EDP servicing section has been revised for the April 1997 revision of Regulation Y by removing requirements for written agreements and providing for the limited processing and transmission of data that are not financial, banking, or economic.
3210.0	3210.0	This payment instruments section was revised to reflect the Board's removal of the limitation on the face amount of such instruments (see the April 1997 Regulation Y revision).
3220.0	3220.0	The arranging of real estate equity financing section reflects the removal of two limitations on the nonbanking activity (see the April 1997 Regulation Y revision).
	3600.22	This section is deleted since it is incorporated into section 3150.0
5030.0, page 4	5030.0, page 4	Illustrative report page—title change only.
5052.0		This section provides targeted inspection guidance for management information systems (MIS) for the examiner's use in determining whether adequate systems are in place that will provide senior management and the board of directors with sufficient, reliable, and timely data to make informed decisions for monitoring and managing the entity's risks.
2020.2	2020.2	These sections were revised to reflect revised Regulation Y section references and/or additional Board order references.
2190.0.7	2190.0.7	
3090.0	3090.0	
3090.1	3090.1	
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# Bank Holding Company Supervision Manual

## Supplement 12— June 1997

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised super-

visory instructions issued by the Division of Banking Supervision and Regulation since the publication of the December 1996 supplement.

### LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2010.9		This section provides supervisory guidance pertaining to required absences from sensitive positions. See SR-96-37.
2050.0.3.2	2050.0.3.2	These subsections pertain to extensions of credit to BHC officials. They consist of two recent changes to Regulation O. The first change, effective November 4, 1996, permits insiders of a state member bank and of the bank's affiliates to obtain loans under company-wide employee benefit plans. The second change, effective April 1, 1997, states, subject to specified conditions, that Regulation O will not apply to extensions of credit by a member bank to an executive officer or director of an affiliate.
2050.0.3.3	2050.0.3.3	
2070.0	2070.0	This section pertains to tax payments by bank holding companies. The section has been updated with current accounting standards. It also includes information derived from SR-96-26 on the new Subchapter S Internal Revenue Code elections for bank holding companies, initiated by the Small Business Protection Act of 1996.
2124.0		This section provides examination guidance as to risk-focused safety-and-soundness inspections. Risk-focused inspections emphasize effective planning and scoping (including advance risk assessments) to customize the work to correspond with the size and activities of the bank holding company, concentrating examiner resources and transaction testing on areas that focus on the greatest degree of risk. See SR-96-14.
2127.0		This section includes general inspection guidance for evaluating the management of interest-rate risk. It emphasizes the Board's adoption of a joint agency policy statement on interest-rate risk (effective June 26, 1996). See SR-96-13.
2185.0	2185.0	This section includes inspection guidance for section 20 nonbank company subsidiaries of bank holding companies. The section has been revised to include (1) a September 11, 1996, Board press release regarding the interest earned on debt securities that a member bank may hold for its own account; (2) a clarification detailed in an October 30, 1996, Board letter to the ABA Securities Association with respect to the Board's September 11, 1996, action; (3) the November 7, 1996, <i>Federal Register</i> notice on easing or removing restrictions on director, officer, and employee interlocks, cross-marketing activities, and the purchase and sale of financial assets; (4) the December 20, 1996, Board approval of a change (effective March 6, 1997) in the revenue limit from 10 to

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2185.0 continued	2185.0 continued	25 percent and the elimination of the alternative indexed-revenue test; and (5) the January 9, 1997, Board removal of a prudential limitation on prior Board approval for BHC funding of section 20 companies.
3000.0.3, appendix 2	3000.0.3, appendix 2	This appendix has been updated for new nonbanking activities approved by Board order on an individual basis under section 4(c)(8) of the BHC Act.
3000.0.4, appendix 3	3000.0.4, appendix 3	This appendix has a footnote added to item 24 indicating that the previously denied activity, clearing securities options and notes and other financial instruments for the accounts of professional floor traders, was recently approved by the Board on a very limited basis. See 1997 FRB 138.
3030.0	3030.0	This revised section discusses acquisition of DPC shares or assets. The revisions incorporate changes to section 4(c)(2) of the BHC Act, based on the Economic Growth and Regulatory Paperwork Reduction Act of 1996, as well as February 1997 changes to section 225.22(d) of Regulation Y. With System approval, shares and other assets may be held for up to five years. If a good faith effort is made to dispose of the shares, real estate, or other assets within five years, additional extensions for up to five years may be granted, for a maximum extension period of 10 years. Previously, only real estate could be held beyond the initial five years (with System approval).
3070.0	3070.0	<p>This section provides inspection guidance on mortgage banking, updated for Statement of Financial Accounting Standards (SFAS) No. 125, “Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities” (issued in June 1996 and amended in December 1996). Mortgage-servicing rights and excess servicing-fee and certain interest-only strips receivables are now termed mortgage-servicing assets.</p> <p>SFAS 125 uses a consistent financial-components approach that emphasizes control. When financial assets are transferred, a BHC should recognize the financial and servicing assets it controls and the liabilities it has incurred. It should remove the financial assets from the balance sheet when control has been surrendered, and liabilities should also be removed from the balance sheet when they have been extinguished.</p> <p>SFAS 125 provides consistent standards for determining whether transfers of financial assets should be treated as sales or secured borrowings. The Financial Accounting Standards Board has deferred until January 1, 1998, the provisions that govern transactions such as secured borrowings and collateral arrangements, repurchase agreements, and securities lending.</p> <p>References to SFAS 122, “Accounting for Mortgage Servicing Rights,” have been deleted or revised based on SFAS 125.</p>

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
3160.2		This section supplements EDP servicing. It summarizes the Board's decision that electronic benefit transfer, stored-value card (open and closed systems), and electronic data interchange services (capturing, formatting, and furnishing merchant sales data) are activities that are closely related to banking, permissible under section 225.28(b)(14) of Regulation Y.
3160.3		This supplemental section to EDP servicing briefly summarizes the Board's decision that the withdrawal of funds from a bank account in the form of travelers' checks, money orders, and postage stamps, using an ATM card and an ATM machine, is an activity closely related to banking, permissible under section 225.28(b)(14) of Regulation Y.
3160.4		This supplemental section to EDP servicing summarizes the Board's decision that providing data processing services in connection with the distribution, through ATMs, of tickets, gift certificates, and prepaid telephone cards is an activity that is closely related to banking, permissible under section 228.25(b)(14) of Regulation Y.
3230.4	3600.19	This section discusses riskless-principal and private-placement nonbanking activities, including summaries of respective Board orders and the February 1997 revision to section 228.25(b)(7) of Regulation Y.
3600.13.14		Two new nonbanking activities, approved only by Board order, are discussed: (1) operating a primary clearing firm for a limited number of floor traders and (2) providing brokerage services for forward contracts on financial and nonfinancial commodities. See 1997 FRB 138.
4060.3.2	4060.3.2	This subsection provides an overview of the capital adequacy guidelines using the risk-based measure. Reference is made to the <i>Trading Activities Manual</i> for more detailed examiner guidance on evaluating the applicability and adequacy of capital charges for market risk resulting from trading activities.
4060.3.2.1.1.4		This revision conveys the Board's October 21, 1996, announcement that certain cumulative preferred stock instruments can be included in tier 1 capital for BHCs. The instruments are marketed under a variety of proprietary names and are issued from a special-purpose subsidiary that is wholly owned by the parent company. The proceeds are lent to the parent in the form of a very long-term, deeply subordinated note.  Cumulative preferred stock of a bank holding company is limited to 25 percent of tier 1 capital.
4070.0.8 4070.0.8.1	4070.0.8 4070.0.8.1	These subsections address the rating of consolidated bank holding company capital under the BOPEC rating system. The subsections have been updated to reflect the application of the current capital measures.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
4070.0.9 5010.4	4070.0.9 5010.4	These sections have been revised to indicate that the BOPEC composite rating, as well as its components, will be disclosed, the latter beginning January 1, 1997. Section 5010.4 provides an example of how the information should be reported. See SR-96-26.
5010.5	5010.5	This section provides clarified nonbank loan-review reporting instructions for the Scope of Inspection and Abbreviations report page.
5010.7	5010.7	This section provides report instructions for the bank holding company’s audit program. The section is revised to reflect a change for the asset threshold of \$500 million or more for independent audits for the FR Y-6 annual report.
2010.2 2110.0.1.1 4010.2 4020.9 4070.04 4080.0 5000.0.4.2 5010.17 5010.41	2010.2 2110.0.1.1 4010.2 4020.9 4070.04 4080.0 5000.0.4.2 5010.17 5010.41	These sections were revised on a limited basis to reflect the Board’s December 24, 1996, adoption of a revised Uniform Financial Institutions Rating System on an interagency basis. Included in that system is the revised CAMELS rating system for banks. The new “S” component will focus on an institution’s ability to monitor and manage market risk. See SR-96-38.

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# Bank Holding Company Supervision Manual

## Supplement 11—December 1996

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and new or revised supervisory instructions issued by the Division of Banking Supervision and Regulation since the publication of the June 1996 supplement.

To make the contents easier to use, a general table of contents and detailed contents pages for each of the major parts of the manual are included with this update.

### LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2129.0		This section consists of supervisory and examiner guidance on the use of credit derivatives by banking organizations. The guidance focuses on the use of credit derivatives for risk management, yield enhancement, reduction of credit concentrations, or diversification of overall risk. Emphasis is placed on establishing sound risk-management policies and procedures and effective internal controls with respect to credit derivatives. See SR-96-17. See also subsections 4060.3.5.3.9 and 4060.3.11 for information on the risk-based capital treatment for credit derivatives.
3000.0.3, appendix 2	3000.0.3, appendix 2	This appendix has been updated for new nonbanking activities approved by Board order on an individual basis under section 4(c)(8) of the BHC Act.
3000.0.4, appendix 3	3000.0.4, appendix 3	This section is revised to reflect Board orders that authorized the trading in platinum and palladium coin and bullion as nonbanking activities; these were nonbanking activities previously denied by the Board.
3130.1	3130.1	This section is revised for the Board's adoption of a final rule amending its interpretive rule, effective September 30, 1996, regarding investment adviser activities of bank holding companies. The new rule allows a bank holding company (and its bank and nonbank subsidiaries) to purchase, in a fiduciary capacity, securities of an investment company advised by the bank holding company if the purchase is specifically authorized by the terms of the instrument creating the fiduciary relationship, by court order, or by the law of the jurisdiction under which the trust is administered.
3230.0.4 3230.0.11.1	3230.0.4 3230.0.11.1	These subsections have been revised to reflect the Board's decision to rescind a June 27, 1986, staff interpretive letter (the so-called "Sovran Letter"). The letter set forth restrictions that a bank holding company had to abide by in selling mutual fund and unit investment trust shares through a nonbank subsidiary engaged in securities brokerage.
3600.3	3600.3	This section was revised to reflect the Board's order authorizing a bank holding company to trade in palladium coin and bullion.



<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
3600.13.12		This new subsection discusses the Board’s order authorizing FCM execution, clearance, and advisory nonbanking services for contracts on financial and nonfinancial commodities for noninstitutional investors.
3600.13.13		This new subsection is a summary of the Board’s order authorizing a bank holding company’s wholly owned asset-management nonbank subsidiary to serve as a commodity pool operator of investment funds involved in purchasing and selling futures and options on futures on certain financial and nonfinancial commodities (“commodity pools”).
3600.15.5		This subsection reflects the Board’s order authorizing a nonbanking activity involving the acquisition of defaulted debt.
3600.16.2		This new subsection discusses the Board’s order authorizing education-financing and advisory services as a nonbanking activity for bank holding companies.
3600.21.6		This subsection summarizes the Board’s order authorizing limited nonbanking activities to underwrite “private ownership” industrial development bonds issued for the provision of certain “traditional governmental services.”
3600.29		This section summarizes the Board’s order authorizing as a nonbanking activity a bank holding company’s providing of employment histories to third parties for a fee.
3600.30		This section discusses the Board’s authorization of real estate title abstracting as a nonbanking activity for bank holding companies.
3600.31		This section reflects the Board’s order authorizing a bank holding company to engage in the nonbanking activity of transmitting money for customers located in the United States to third parties located in a foreign country.
4060.3.2	4060.3.2	This subsection has been revised to alert examiners to the existence of supplemental risk-based capital rules (Regulation Y, appendix E) that adjust the risk-based capital for market risk involved in trading activities.
4060.3.5.3.9 4060.3.11	4060.3.11	These subsections address the risk-based capital treatment of credit derivatives. See section 2129.0 and SR-96-17.

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# Bank Holding Company Supervision Manual

## Supplement 10—June 1996

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and supervisory instruc-

tions issued by the Division of Banking Supervision and Regulation since the publication of the December 1995 supplement.

### LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2020.1.1	2020.1.1	This subsection has been revised to include the Board's April 29, 1996, adoption of a definition of capital stock and surplus for purposes of section 23A of the Federal Reserve Act that is effective July 1, 1996. The definition conforms to the definition of unimpaired capital stock and unimpaired surplus used by the Federal Reserve Board in calculating the limits in Regulation O for insider lending and by the Office of the Comptroller of the Currency in calculating the limit on loans by a national bank to a single borrower.
2050.0.3.2	2050.0.3.2	This subsection has been amended for the Board's June 7, 1995, adoption of an amendment to Regulation O to conform the definition of unimpaired capital and unimpaired surplus to the definition of capital and surplus adopted by the OCC mentioned above. The final rule became effective on July 1, 1995.
3000.0, Appendix 2	3000.0, Appendix 2	This appendix has been updated for new nonbanking activities approved by Board order on an individual basis under section 4(c)(8) of the BHC Act.
3070.0	3070.0	This section has been completely revised to incorporate new mortgage banking inspection procedures for nonbanking subsidiaries of bank holding companies. The procedures were developed by a Federal Reserve System task force for use in conducting examinations or inspections of mortgage banking subsidiaries of state member banks or bank holding companies. The procedures primarily focus on board oversight and management, activities such as production, marketing, servicing/loan administration, financial analysis, mortgage-servicing rights, and intercompany transactions.
3240.0	3240.0	This section has been revised to delete information that is no longer applicable to underwriting and dealing in U.S. obligations, municipal securities, and money market instruments.
3600.3	3600.3	This section now includes the Board's order authorizing a BHC's section 20 subsidiary to trade platinum coin and bullion for its own account, a new nonbanking activity under section 4(c)(8) of the BHC Act. See 1995 FRB 190.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
3600.13.5		This new section reflects the Board's approval by order of a BHC's application for its section 20 subsidiary to engage as an FCM in executing and clearing, and clearing without executing, futures and options on futures on nonfinancial commodities as a nonbanking activity under section 4(c)(8) of the BHC Act. See 1993 FRB 1049.
3600.13.6		This new section discusses the Board's approval of an order authorizing a new FCM nonbanking activity under section 4(c)(8) of the BHC Act—providing FCM and related advisory services for options on Eurotop 100 index futures and one-month Canadian banker's acceptance futures. See 1995 FRB 188–189.
3600.13.7		This new section summarizes the Board's approval of an order for a section 20 company to act as an FCM in trading for its own account, for purposes other than hedging, in futures, options, and options on futures contracts based on certificates of deposit or other money market instruments per section 4(c)(8) of the BHC Act. See 1995 FRB 190.
3600.13.8		This new section reviews an order whereby the Board authorized, under section 4(c)(8) of the BHC Act, for a section 20 company to act as an originator, principal, agent, broker, or advisor with respect to commodity and index swap transactions. See 1995 FRB 185.
3600.13.9		This new section addresses the Board's approval of an order authorizing, under section 4(c)(8) of the BHC Act, an FCM to trade for one's own account, for purposes other than hedging, in futures, options, and options on futures contracts based on commodities or on stock, bond, or commodity indices. See 1995 FRB 192–193.
3600.13.10		This new section summarizes the prior-approval requirements for BHCs proposing to engage in FCM activities under section 4(c)(8) of the BHC Act. See SR-95-14.
3600.13.11		This new section reflects the Board's approval of a BHC's application to provide discretionary portfolio management services on futures and options on futures on financial commodities in combination with FCM transactional services under section 4(c)(8) of the BHC Act. See 1995 FRB 386.
3600.18.4		This new section discusses the Board's approval of a BHC's application to provide discretionary portfolio management services on futures and options on futures on nonfinancial commodities under section 4(c)(8) of the BHC Act. See 1995 FRB 803.
4070.1		This new section provides guidance for evaluating risk-management systems of BHCs. System examiners now assign a supervisory rating to the adequacy of a BHC's risk-management processes. See SR-95-51.

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# Bank Holding Company Supervision Manual

## Supplement 9—December 1995

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and supervisory instruc-

tions issued by the Division of Banking Supervision and Regulation since the publication of the June 1995 supplement.

### LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2010.6	2010.6	This section has been revised to include SR-95-46, a discussion of a September 12, 1995, joint interagency interpretation of the February 17, 1994, Interagency Statement on Retail Sales of Nondeposit Investment Products (SR-94-11) and on using abbreviated disclosures under certain circumstances.
2010.7	2010.7	These sections have been amended to provide examiner guidance on assessing the portion of the allowance for loan and lease losses (ALLL) for impaired loans (see SR-95-38). Examiners, however, should focus primarily on the assessment of the adequacy of the <i>overall</i> ALLL. The guidance gives recognition to revisions of Financial Accounting Standards Board Statement Nos. 114 and 118 (FAS 114 and FAS 118). FAS 114 and FAS 118 set standards for estimating the impairment of a loan for general financial reporting purposes.
2065.1	2065.1	
2065.2	2065.2	
4060.3.5.1.1.1	4060.3.5.1.1.1	These subsections have been revised to include the Board's adoption of an interim final rule on July 26, 1995 (effective August 1, 1995). The rule change was adopted in response to the Financial Accounting Standards Board's Statement No. 122, "Accounting for Mortgage-Servicing Rights" (FAS 122). FAS 122 requires originated mortgage-servicing rights (OMSRs) to be treated the same as purchased mortgage-servicing rights (PMSRs), that is, capitalized as balance-sheet assets (see section 4060.4 below). Under the interim rule, both OMSRs and PMSRs are "included in" (not deducted from) regulatory capital when determining Tier 1 (core) capital, subject to the regulatory capital limitations that previously applied only to PMSRs.
4060.3.5.1.1.2	4060.3.5.1.1.2	
4060.3.5.1.3	4060.3.5.1.3	
4060.3.5.2.4		This new subsection reflects the Board's August 25, 1995, adoption of a final rule (effective September 1, 1995) amending the risk-based measure of the capital adequacy guidelines. Risk-weighted assets used to calculate capital ratios can include only the amount of retained recourse for transfers of small-business loans and leases on personal property. The rule has the effect of lowering capital requirements for small-business loans and leases on personal property that have been transferred with recourse by qualified banking organizations.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
4060.3.5.3.4 4060.3.5.3.4.1 4060.3.5.3.4.2 4060.3.5.3.6	4060.3.5.3.4 4060.3.5.3.4.1 4060.3.5.3.4.2 4060.3.5.3.6	These subsections have been revised to include the Board's August 25, 1995, adoption of final rule amendments (effective October 1, 1995) to the risk-based measure of the capital adequacy guidelines for bank holding companies. The changes are three-fold: First, new conversion factors have been added for long-dated interest-rate and exchange-rate contracts and for derivative contracts related to equities, precious metals, and other commodities. Second, recognition is given to the effects of netting arrangements in calculating potential future credit exposure for contracts subject to qualifying bilateral netting arrangements. Third, derivative contracts related to equities, precious metals, and other commodities are recognized in bilateral netting arrangements.
4060.4	4060.4	This section has also been revised to treat OMSRs the same as PMSRs for the leverage measure of the capital adequacy guidelines, in accordance with the Board's July 26, 1995, adoption of the above-mentioned interim rule.
4080.0	4080.0	This section has been substantially revised to include revisions to the Systemwide Bank Holding Company Surveillance Program. The changes (1) incorporate SEER and CAMEL ratings into the program, (2) vary the exceptions based on the condition of the banking industry, (3) incorporate supplemental screens, (4) provide a monitoring tool for BHCs with assets below \$150 million, and (5) improve communication within the Reserve Bank System. See SR-95-43.

FILING INSTRUCTIONS

<i>Remove</i>	<i>Insert</i>
Title Page	Title Page
1010.0, page 2.1 pages 5 and 6 pages 29 and 30 pages 35 through 38	1010.0, page 2.1 pages 5 and 6 pages 29 and 30 pages 35 through 38 and 38.1
2010.6, pages 1 through 18	2010.6, pages 1 through 20
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2065.2, pages 1 and 2	2065.2, pages 1 through 3
3090.2, pages 3 and 4	3090.2, pages 3 and 4
3170.0, pages 7 and 8	3170.0, pages 7 and 8



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4060.3, pages 1 through 14  
pages 14.1 through 14.5  
pages 15 through 26

4060.3, pages 1 through 16 and 16.1  
pages 17 through 33

4060.4, pages 1 and 2

4060.4, pages 1 and 2

4080.0, page 1

4080.0, pages 1 through 5

5030.0, pages 3 and 4

5030.0, pages 3 and 4

6000.0, pages 1 through 46

6000.0, pages 1 through 46

# Bank Holding Company Supervision Manual

## Supplement 8—June 1995

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and supervisory instruc-

tions issued by the Division of Banking Supervision and Regulation since the publication of the December 1994 supplement.

### LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2010.8		This new section includes examiner guidance on the sharing of corporate facilities and staff within banking organizations. When officials and employees have responsibilities for offices or affiliates of a banking organization, particularly those that share facilities, those responsibilities should be clearly defined and, when appropriate, disclosed or made clear to customers and the public in general. Furthermore, in establishing staff responsibilities, management should ensure that they are within the scope of the entity's license or charter and that each staff member who makes a commitment to a counterparty on behalf of an entity has both the corporate legal authority and capacity to do so. See SR-95-34 (SUP).
2126.0		<p>This new section pertains to the inspection of nontrading activities of BHCs and their subsidiaries. It provides examiner guidance on evaluating the risk-management practices and internal controls used by banking organizations in acquiring and managing securities and off-balance-sheet derivative contracts for "nontrading" purposes. When evaluating nontrading activities, examiners must ensure that banking organizations employ sound risk-management practices consistently across these varying product categories, regardless of legal characteristics or nomenclature.</p> <p>These basic principles emphasize controlling aggregate risk exposures on a consolidated basis, while recognizing legal distinctions and possible obstacles to cash movements among subsidiaries. More generally, the principles set forth fundamental risk-management practices that are relevant to most portfolio-management endeavors. See SR-95-17.</p>
2185.0.5.2.1 2185.0.5.2.4.3	2185.0.5.2.1 2185.0.5.2.4.3	These Section 20 nonbank company inspection procedures have been enhanced for infrastructure inspections pertaining to equity underwriting and dealing. Further guidance is provided as to definitional and other issues relating to preferred stock, convertible debt securities, and the acquisition of voting shares of a nonbank company.
2185.0.5.4.7	2185.0.5.4.7	The Section 20 nonbank company inspection procedures are revised to emphasize that bank affiliates generally may not act as agent or engage in marketing activities for bank-ineligible securities underwriting. It is noted that the Board, by Order, has permitted Regulation K affiliates to act as an agent for a Section 20 company for bank-ineligible securities transactions.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2185.0.7	2185.0.7	Condition 16 of the 1989 Board Order (equivalent to Condition 13 of the Board's 1987 Order) has been interpreted to permit Section 20 subsidiary personnel to participate in educational seminars (marketing) sponsored or cosponsored by affiliates. Condition 16 no longer precludes affiliate banks and thrifts from acting as agent for or engaging in marketing activities on behalf of an affiliate Section 20 company with respect to bank-eligible securities.
2185.0.8	2185.0.8	The 1987 Board Order discussion as to the types of securities that can be underwritten is revised to include unrated municipal revenue bonds under certain conditions. (See the Board's Norwest letter of December 5, 1994, now contained in Appendix G.)
2185.0.14		Appendix H has been added for the Board's December 14, 1994, Interpretation of the Limitation on Cross-Marketing Activities.
2231.0	2231.0	The Federal Reserve Board emphasizes the importance of administering sound appraisal policies and procedures in a banking organization. This revised section reflects the Board's changes to its Real Estate Appraisal Regulation, adopted in June 1994. The narrative, examiner guidance, and inspection procedures are revised. A banking organization's board of directors is responsible for adopting policies and procedures that establish effective real estate appraisal and evaluation programs. See SR-94-50 and SR-94-55.
3000.0	3000.0	Appendix 2 of this section is revised to incorporate 1994 and 1995 Board Order approvals of new nonbanking activities that pertain to data processing, futures commission merchant, trading, and underwriting and dealing activities.
3500.0	3500.0	This section is revised to for the Board's December 15, 1994, and April 20, 1995, exceptions to the anti-tying prohibitions of Regulation Y. One exception permits a BHC or its nonbank subsidiary to offer a discount on its product or service on the condition that a customer obtain any other product or service from that company or from any of its nonbank affiliates. The other new exception, the "safe harbor" exception, permits any bank or nonbank subsidiary of a bank holding company to offer a "combined-balance discount"—that is, a discount based on a customer maintaining a combined minimum balance in products specified by the company offering the discount.
4060.3	4060.3	This section includes the Board's December 1994 and February 1995 revisions to the Capital Adequacy Guidelines for bank holding companies (the December 1, 5, 16, 1994, and the February 7, 1995, Board approvals). The following comments summarize specific changes to each subsection.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
4060.3.2.1.1 4060.3.5.1.4	4060.3.2.1.1	These subsections are either revised or added for the December 5, 1994, Board approval for the definition of common stockholders' equity. The revised definition excludes net unrealized holding gains (losses) on securities available for sale in regulatory capital. Also discussed is the exclusion of revaluation reserves in capital ratio calculations (risk-based capital and leverage measures).
4060.3.5.1.3	4060.3.5.1.3	This subsection is revised for the Board's December 16, 1994, approval that established a limit on the amount of deferred-tax assets that can be included in Tier 1 capital for risk-based capital purposes.
4060.3.5.3.4 4060.3.5.3.4.2 4060.3.5.3.6	4060.3.5.3.6	Under the December 1, 1994, approval, the Board recognized the risk-reducing benefits of qualifying bilateral netting contracts. Bank holding companies with such contracts are permitted to net positive and negative mark-to-market values of interest-rate and exchange-rate contracts in determining the current exposure portion of the credit-equivalent amount of such contracts to be included in risk-weighted assets. The change implements a revision to the Basle Accord that permits such netting arrangements.
4060.3.5.3.7	4060.3.5.3.7	A new footnote results from the Board's February 7, 1995, approval regarding the risk-based capital treatment of recourse transactions. Previously, a banking organization could have been required to hold capital in excess of the maximum amount of loss possible under the contractual terms of a recourse obligation.
4060.3.5.3.8		Additional risk-based capital guidance is provided for off-balance-sheet instruments, specifically financial standby letters of credit and performance standby letters of credit. See SR-95-20, issued March 30, 1995.
4060.4.1 4060.4.2.2	4060.4.1 4060.4.2.2	These subsections are revised for the Board's December 16, 1994, approval that establishes a limit on the amount of deferred-tax assets that can be included in Tier 1 capital for leverage capital purposes.
5000.0.9.2.1.1 5000.0.9.2.1.2	5000.0.9.2.1.1 5000.0.9.2.1.2	These subsections were revised based on the guidance of SR-95-19 pertaining to meetings by Reserve Bank officers and staff with BHC officials pertaining to the holding company's inspection.
5000.0.9.3 5010.1 5010.4 5010.6 5010.7 5010.30 5010.38 5030.0	5000.0.9.3 5010.1 5010.4 5010.5 5010.6 5010.30 5030.0	These sections are revised to reflect changes to the guidance for preparing the Bank Holding Company Inspection Reports and in the requirements for the issuance of Director's Summaries of Inspection Findings. The changes are the outgrowth of work done by the Task Force of the Supervision Efficiency Enhancement Project. See SR-95-12.  Some reorganization of the sections was necessary to accommodate the changes. 5010.6 was combined with 5010.5; 5010.7 replaced 5010.6; and 5010.34 was moved to 5010.7. Similar changes were made to the illustrated report pages in 5030.0.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
5060.0		This is a new section that pertains to portions of BHC inspections that are conducted in Reserve Bank offices. See SR-95-13.

FILING INSTRUCTIONS

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	2010.8, page 1
	2126.0, pages 1 through 12
2185.0, pages 3 through 8, 8.1, 9, and 10 pages 19 through 28 pages 49 and 50	2185.0, pages 3 through 10 and 10.1 pages 19 through 28 pages 49 through 56
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5010.8, page 1	5010.8, page 1
5010.9, page 1	5010.9, page 1
5010.10, pages 1 through 4	5010.10, pages 1 through 4

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5010.11, page 1

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5010.30, page 1

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pages 5 through 8  
pages 39 through 44 and 44.1

5060.0, pages 1 through 11

6000.0, pages 1 through 50

6000.0, pages 1 through 46

# Bank Holding Company Supervision Manual

## Supplement 7—December 1994

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and supervisory instruc-

tions issued by the Division of Banking Supervision and Regulation since the publication of the June 1994 supplement.

### LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
2010.6.2		Section 2010.6 primarily addresses a BHC's supervision of its banking subsidiaries as it pertains to the retail sales of nondeposit investment products, including mutual funds and annuities. The section consists of a February 15, 1994, interagency policy statement that provides comprehensive guidance on retail sales of such products. A new subsection 2010.6.2 adds respective examination/inspection procedures applicable to state member banks and in some situations, BHCs and their depository institution and non-banking subsidiaries (including their affiliate relationships).
2050.0	2050.0	This section was revised to incorporate a few technical amendments to Regulation O that became effective July 19, 1994. Regulation O was significantly amended by a final rule published in the <i>Federal Register</i> (59 FR 8831) on February 24, 1994.
2128.0		This new section discusses structured notes and their increased use by banking organizations. SR-94-45, dated August 17, 1994, instructs examiners to be mindful of these securities when examining banking organizations. Some structured notes can expose investors to significant losses as interest rates, foreign-exchange rates, and other market indices change. Examiners need to ensure that structured notes are held in accordance with the organization's investment policies and procedures that convey a full understanding of the risks and price sensitivities of structured notes under a broad range of market conditions.
3500.0	3500.0	This section addresses the tie-in considerations of the BHC Act. The section has been revised to include the Board's July 27, 1994, limited extension of a statutory exception to BHC affiliates (bank and nonbank) to offer package discounts on traditional bank products, which are already available to banks. The exception was approved through a revision to Regulation Y. The final rule also permits BHC affiliates to offer a discount on securities brokerage services on the condition that a customer obtain a traditional bank product from itself or from an affiliate.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change</i>
5000.0.1 5010.0 5010.1.3 5010.2  5030.0 5040.0 5050.0	5000.0.1 5010.0 5010.1.3 5010.2 5010.44 5030.0 5040.0 5050.0	These sections were revised as a result of changes to the Federal Reserve System's Supervisory Information System (SIS), effective July 18, 1994. The changes were conveyed to System staff by SR-94-38, June 20, 1994. Of particular note are the instructions pertaining to the assignment of BOPEC composite and component ratings for targeted BHC inspections in section 5050.0; changes made to the inspection report cover pages; and the elimination of the Inspection Summary (FR 1417 and FR 1417a [confidential page E]) from the inspection report.
5000.0.12		This new subsection discusses the conditions under which a combined examination/inspection report may be issued for BHCs with lead state member banks. The format for the report is attached to SR-94-46, August 17, 1994.
5030.0 (page 10)	5030.0 (page 10)	Core page 7 (Consolidated Classified & Special Mention Assets, & OTRP) of the BHC inspection report has been slightly revised so columnar information can be totalled. A separate total is also provided to report total classified assets (substandard, doubtful, loss, and value impaired).

FILING INSTRUCTIONS

<i>Remove</i>	<i>Insert</i>
Title page	Title page
1010.0, pages 1 and 2 pages 9 and 10 pages 29 and 30 pages 39 through 43	1010.0, pages 1, 2, and 2.1 pages 9 and 10 pages 29 and 30 pages 39 through 43
2010.6, pages 5 and 6	2010.6, pages 5 through 18
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3500.0, pages 1 through 4	3500.0, pages 1 through 4
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5010.0, pages 1 and 2	5010.0, pages 1 and 2
5010.1, pages 1 through 3	5010.1, pages 1 through 3
5010.2, pages 1 and 2	5010.2, pages 1 and 2
5010.44, page 1	



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5030.0, pages 1 and 2  
pages 9 and 10

5030.0, pages 1 and 2  
pages 9 and 10

5040.0, pages 1 through 4

5040.0, pages 1 through 4

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Bank Holding Company Supervision Manual

Supplement 6—June 1994

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and supervisory instructions issued by the Division of Banking Supervision and Regulation from January 1994 to June 1994. In addition to the changes described below, several pages are being reissued to correct typographical or formatting errors.

LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of Changes</i>
2010.6		This new section applies to a BHC's supervision of its banking subsidiaries as it pertains to the retail sales of nondeposit investment products, including mutual funds and annuities. The section consists of a February 15, 1994, interagency policy statement that provides comprehensive guidance on retail sales of such products. The statement applies to all depository institutions, including state member banks, and to the U.S. branches and agencies of foreign banks supervised by the Federal Reserve. See SR-94-11.
2010.7		This new section contains the text of a December 21, 1993, interagency joint policy statement on the maintenance of an adequate allowance for loan and lease losses and an effective loan review system, as adopted by the Board. Although the policy statement does not apply directly to bank holding companies, the board of directors and management of BHCs should consider this statement as they supervise the BHC's financial institution subsidiaries. BHC examiners should consider the guidance when evaluating the holding company's supervision of those subsidiaries.
2050.0	2050.0	This section pertains to extensions of credit to BHC officials. The section has been extensively revised to include changes resulting from the Board's February 18, 1994, revision of Regulation O (Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks). Subsection 2050.0.3.1 has been revised to provide an updated and more detailed summary of changes for the 1992 Regulation O revisions as well as for the 1994 revisions.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of Changes</i>
2125.0		This new section addresses the review of risk management and internal controls with regard to the BHC inspection of trading activities. The guidance highlights key considerations when inspecting trading activities in both cash and derivative instruments. This guidance specifically targets trading, market making, and customer accommodation activities in cash and derivative instruments at state member banks, branches and agencies of foreign banks, and Edge corporations. The principles set forth in this guidance also apply to the risk management of BHCs, which should manage and control aggregate risk exposures on a consolidated basis while recognizing legal distinctions among subsidiaries. Many of the principles advanced can also be applied to banks' use of derivatives as end-users. Examiners should assess management's application of this guidance to the holding company and to a bank's end-user derivative activities where appropriate, given the nature of the institution's activities and current accounting standards. See SR-93-69 (December 20, 1993) and SR-94-17 (March 1, 1994).
3000.0	3000.0	This section was revised to discuss BHC nonbanking activities in foreign countries permissible under section 211.5 of Regulation K and any other nonbanking activities that must be approved by the Board. The paragraph discussing an Edge Act and agreement corporation has been revised and expanded to correctly reference permissible activities under section 4 of the BHC Act and Regulation K as they pertain to this entity. Also, appendix 2 in subsection 3000.0.3 has been updated for new nonbanking activities adopted by Board order.
3160.0	3160.0	This revised section describes the updated standards for data processing and transmission services as set forth in section 225.25(b)(7) of Regulation Y and its interpretation at section 225.123(e). Also, subsection 3160.0.13 has been revised to incorporate a December 22, 1993, Board order authorizing a BHC to engage in the processing and transmission of medical-payment data and to provide other incidental services (see 1994 FRB 139).

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of Changes</i>
3160.1		This new section summarizes the Board's approval of a BHC's application to provide a network for the processing and transmission of medical-payment data through its designated nonbank subsidiary. The December 22, 1993, Board order concludes that (1) the operation of a medical-payments network would constitute a permissible data processing and data transmission activity under section 4(c)(8) of the BHC Act and section 225.25(b)(7) of the Board's Regulation Y; (2) the provision of claims-adjudication software that processes medical and coverage data is permissible as an activity incidental to the proposed provision of software for the processing of banking and financial data and the proposed operation of a medical-payments network; and (3) the proposed electronic data interchange services would constitute permissible byproducts of the nonbank subsidiary's primary data processing activities, and that such services are therefore permissible as an incidental activity. See 1994 FRB 139.
3510.0	3510.0	This section has been revised to provide additional explanation of the regulatory framework governing the nonbanking activities of foreign banking organizations (FBOs) under 12 C.F.R. 211.23. The section discusses 1991–1993 revisions to Regulation K pertaining to the nonbanking activities of and investment in qualifying foreign banking organizations (QFBO). The definition of and the requirements under the QFBO test have been expanded. Also, the manual's discussion of nonbanking exemptions for QFBOs under section 4(c)(9) and section 2(h) of the BHC Act has been significantly expanded to discuss the limitations on investments in FBOs and permissible QFBO nonbanking activities. FBOs may also engage in certain otherwise nonpermissible activities under section 4(c)(9) if approved by Board order.
3600.12.5		This new subsection has been added to include the Board's November 12, 1992, approval of a BHC's application to issue and sell, through its nonbank subsidiary, variably denominated payment instruments without limitation as to face value. See 1993 FRB 42.
3600.15.1.1		This new subsection summarizes the Board's approval of a bank holding application to engage in career counseling services as a new nonbanking activity under section 4(c)(8) of the BHC Act, permissible only by Board order. The applicant proposed to expand its present career counseling services under section 4(c)(1)(C) of the BHC Act nationwide to unaffiliated companies and individuals in a wide array of industries. The Board approved the application, but indicated that the applicant was not to portray itself as a provider of general career counseling services for individuals seeking career opportunities outside the banking or financial industries. See 1994 FRB 51.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of Changes</i>
3600.15.4		This new subsection includes the Board’s December 21, 1992, approval under section 4(c)(8) of the BHC Act of an application by two BHCs to engage, through BHC nonbank subsidiaries, in asset management activities involving assets originated by non-financial institutions as well as by financial institutions. The originated assets are limited to the types of assets that a financial institution would have the authority to originate. See 1993 FRB 131.
3600.21.5		This new subsection discusses the Board’s approval of a BHC’s application for its section 20 nonbank subsidiary to underwrite and deal in all types of equity securities and to act as a dealer-manager in connection with cash-tender and exchange-offer transactions (see 1994 FRB 49, footnote 5). In addition, recent Board order references to debt and equity approvals have been updated.
4060.3.5.2.2, 4060.3.5.2.3, 4060.3.5.3.7	4060.3.5.2.2, 4060.3.5.2.3, 4060.3.5.3.7	This revised subsection reflects the Board’s adoption of amendments to its risk-based capital guidelines for state member banks and bank holding companies. The revised guidelines lower the risk weight from 100 percent to 50 percent for multifamily housing loans meeting certain criteria. The changes became effective on December 31, 1993. This change was directed by a provision of section 618(b) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991.
4060.8.4.2, 5010.0, 5010.1.1, 5010.10, 5010.29, 5010.31, 5030.0, and 5040.0	4060.8.4.2, 5010.0, 5010.1.1, 5010.10, 5010.29, 5010.31, 5030.0, and 5040.0	References to “criticized” assets or risk exposures in these sections have been redesignated as “classified,” in accordance with the Board’s adoption of the June 10, 1993, “Interagency Statement on the Supervisory Definition of Special Mention Assets.” See SR-93-30.

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2050.0, pages 1 through 9	2050.0, pages 1 through 12
2090.3, pages 1 and 2	2090.3, pages 1 and 2  2125.0, pages 1 through 8
2187.0, pages 1 through 4	2187.0, pages 1 through 4

<i>Remove</i>	<i>Insert</i>
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6000.0, pages 1 through 49	6000.0, pages 1 through 50

Bank Holding Company Supervision Manual

Supplement 5—December 1993

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, and supervisory instructions issued by the Division of Banking Supervision and Regulation from July 1993 to December 1993. In addition to the changes described below, several pages are being reissued to correct typographical errors.

LIST OF CHANGES

New Section Number	Previous Section Number	Description of Changes
2020.6	2020.6	This section has been revised to indicate that fee assessments against subsidiary financial institutions may take many forms. Such assessments represent an area of potential abuse because they can directly affect the cash-flow position of the affiliate. The section emphasizes that examiners must judge the reasonableness of fees assessed based on the services provided. Fees should be based on the fair market value of the services provided (or cost of the service plus a reasonable profit). In addition, fee assessments should be supported by written agreements that specify the services to be provided, the basis for the fees, and the method of their allocation.
2020.8		This new section addresses the improper practice of a bank holding company's assessing trade-name or royalty fees on its subsidiary banks. This practice is viewed as a diversion of bank income. See SR-91-3.
2020.9		This new section discusses safety-and-soundness concerns with regard to split-dollar life insurance policy arrangements between BHCs and their subsidiary banks. Such arrangements may be inconsistent with the Federal Reserve Act, sections 23A and 23B. Inspection objectives and procedures are provided. See SR-93-37.
2065.1 2065.1.4.1 2065.1.4.2 2065.1.7 2065.1.8	2065.1	This section has been revised to include the June 10, 1993, interagency credit-availability initiatives. The initiatives supplement the March 10, 1993, policy to improve credit availability. The June 10 initiatives included in this section address insubstance foreclosures and returning nonaccrual loans to accrual status. Also included is a statement that it is <i>not</i> regulatory policy to value real estate collateral on a liquidation basis.
2187.0		This new section discusses day trading and free-riding schemes (purchasing and selling the same securities, paying for the purchase with the proceeds of the sale). Such schemes involve the opening of a custodial agency account into which a number of broker-dealers will deliver securities on a delivery-versus-payment basis. A bank extension of credit is created, subject to Regulation U, when there are not sufficient funds in the account to pay for the securities and the account is therefore overdrawn. A discussion of securities credit regulations is included. See SR-93-13.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of Changes</i>
3000.0.3	3000.0.3	Appendix 2 has been revised to include additional nonbanking activities that have not been previously approved by the Board under section 4(c)(8) of the BHC Act. The new nonbanking activities involve certain futures commission merchant activities and providing administrative and other services to mutual funds.
3000.0.4	3000.0.4	Footnote 1 of appendix 3 was revised to reflect the Board’s decisions regarding the provision of armored car services as a nonbanking activity. See also the summary of changes to section 3700.10.
3230.0.8	3230.0.8	This subsection has been revised to delete the reference to the Securities and Exchange Commission’s rule (17 C.F.R. 240.3b-9). The courts have ruled that the rule is no longer enforceable.
3600.13.3		This new subsection discusses the Board’s May 6, 1993, approval, by order, of a BHC application to engage in a new FCM nonbanking activity—limited FCM clearing-only and executing-only trades that the FCM itself executes. The application was approved based on (1) the established framework for limiting risk from the clearing-only activities; (2) the fact that the applicant represented that its FCM nonbanking subsidiary could restrict the number of types of positions held by customers and that it could refuse trades that posed unacceptable risks; and (3) the commitments made, as well as the other facts of record.
3600.13.4		This new subsection discusses the Board’s August 2, 1993, approval of a BHC application to engage in a new FCM nonbanking activity—the acceptance for clearance of a customer’s orders that are executed by preapproved execution groups pursuant to “give-up” agreements. The approval was based on the applicant’s framework for limiting risk, including the applicant’s representation that under the give-up agreements the company would have the contractual right to refuse a customer’s trade if it exceeded established trading limits documented in the give-up agreement for that particular customer. Also, the FCM nonbanking subsidiary will approve an execution group only if the floor brokers, and their primary or qualifying clearing firms, satisfy the company’s financial, managerial, and operational standards.
3600.27		This section summarizes the Board’s April 21, 1993, approval for providing administrative and certain other nonbanking services to mutual funds under section 4(c)(8) of the BHC Act. Certain Glass-Steagall Act issues are discussed within the order, and the applicant made several commitments to address those issues. Special emphasis is placed on the fact that the affiliates of banks cannot act as a distributor to the mutual fund. A combination of advisory and administrative services was also proposed.



<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of Changes</i>
3600.28		This new section discusses the Board's September 1993 approval of a BHC's proposal to provide stand-alone inventory-inspection services under section 4(c)(8) of the BHC Act. The inventory-inspection services are to be provided to customers (third-party lenders) and only with respect to inventory that is pledged as collateral for a loan.
3700.10	3700.10	This revised section discusses the Board's denial of a BHC's request to provide armored car services through a de novo non-bank subsidiary. For this application, the Board published an order requiring a formal hearing before an administrative law judge (ALJ) in 1989. The ALJ declined to provide a factual or legal determination concerning the proper-incident test and other unresolved issues. The Board again referred the case to an ALJ for a recommended decision in 1990. In 1993, the Board denied the application in accordance with the ALJ's recommendation. The applicant failed to support a finding that the proposed armored car activities would be a proper incident to banking or to managing or controlling banks. Of particular note is the discussion on potential violations of section 23B of the Federal Reserve Act. Although these were only potential violations noted in an application, they provide noteworthy examples of the nature of such violations.
4020.9		This new section briefly summarizes the supervisory capital standards for de novo state member banks of BHCs and restrictions on their funding of the parent company's debt. See SR-91-17.
5000.0.7.5 5000.0.7.5.1		These subsections set out guidelines that were issued in SR-93-48 to clarify the respective roles of the responsible and local Reserve Banks in conducting inspections of out-of-District second-tier BHCs and nonbank subsidiaries. The responsible Reserve Bank, should, to the extent possible, rely on the local Reserve Bank to provide the resources necessary to conduct these inspections. The guidelines supplement the inter-District inspection guidance issued in SR-89-25 and SR-79-464.
5000.0.8.3		This new subsection sets forth the June 10, 1993, interagency guidance on the coordination of examinations of insured depository institutions and holding companies by the federal financial regulatory agencies. The coordination program is a response to industry concerns about the increased burden on organizations supervised by multiple regulatory agencies. The guidelines have been issued to minimize the disruptions and burdens associated with the examination process. The program emphasizes full cooperation and coordination by the agencies in supervising large banking organizations and organizations that are in less-than-satisfactory condition. The program expands on existing inter-agency agreements.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of Changes</i>
5010.23	5010.23	This revised section expands the commercial-paper inspection-reporting instructions to include information on ratings of investment-quality commercial paper that are issued by statistical rating agencies, master notes and sweep arrangements, credit-supported commercial paper, dealer versus direct paper, yields on commercial paper, and denominations of commercial paper.

FILING INSTRUCTIONS

<i>Remove</i>	<i>Insert</i>
Title page	Title page
1010.0, pages 1 through 12 pages 29 through 40	1010.0, pages 1 through 12 page 12.1 pages 29 through 41
2010.2, pages 1 and 2	2010.2, pages 1 and 2
2020.6, pages 1 through 3	2020.6, pages 1 through 4 2020.8, page 1 2020.9, pages 1 through 5
2050.0, pages 3 through 6	2050.0, pages 3 through 6
2065.1, pages 1 through 3	2065.1, pages 1 through 4 2187.0, pages 1 through 4
3000.0, pages 9 through 12	3000.0, pages 9 through 12
3230.0, pages 3 and 4	3230.0, pages 3 and 4
3600.13, pages 1 and 2	3600.13, pages 1 through 4 3600.27, pages 1 through 3 3600.28, page 1
3700.10, page 1	3700.10, pages 1 through 3 4020.9, page 1
5000.0, pages 5 and 6 pages 6.1 and 6.2 pages 7 and 8	5000.0, pages 5 through 8 pages 8.1 through 8.4
5010.23, pages 1 and 2	5010.23, pages 1 through 3
6000.0, pages 1 through 47	6000.0, pages 1 through 49

# Bank Holding Company Supervision Manual

## Supplement 4—June 1993

This supplement is the first revision of the reformatted December 1992 edition of the *Bank Holding Company Supervision Manual*. It is, however, numbered supplement 4 because it is the fourth supplement issued since the manual was totally revised in 1986. The revisions reflect decisions of the Board of Governors, new and revised statutory and regulatory provisions, and

supervisory instructions issued by the Division of Banking Supervision and Regulation from January to June 1993.

Included in this supplement is a title page on the back of which is a grid for recording the filing of supplements. It is strongly recommended that you use this grid so that you can determine if your manual is up-to-date.

### LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
2010.2	2010.2	This section has been revised to include a discussion of the internal and external factors that should be considered in the formulation of loan policies. Also, the components that form the basis for a sound loan policy for all loans have been amended in light of the Board's December 23, 1992, adoption of a uniform rule and guidelines for state member banks on real estate lending. The section also includes a brief summary of the Board's March 30, 1993, adoption of an interagency policy to encourage small-business lending by state member banks.
2050.0.3.2	2050.0.3.2	The section was revised to implement amendments to Regulation O, effective December 17, 1992. The Board revised the definition of "principal shareholder" in section 215.2(l) of Regulation O to implement recent amendments to section 22(h) of the Federal Reserve Act contained in the Housing and Community Development Act of 1992. This section has been revised to include three exceptions to the aggregate insider lending limit, an amendment to the Board's Regulation O effective May 3, 1993.
2050.0.3.3	2050.0.3.3	
2050.0.3.11	2050.0.3.11	
2130.0	2130.0	The Supervisory Policy Statement on the Selection of Securities Dealers and Unsuitable Investment Practices, issued in 1988, was superseded by the Supervisory Policy Statement on Securities Activities, issued in 1992. References were revised accordingly.
2185.0	2185.0	The revisions of this section, and in particular subsection 2185.0.5.4.2, reflect the Board's adoption of an alternative indexed-revenue test in addition to the present unadjusted-revenue test that has been used over the past several years. Adopted by the Board by order on January 26, 1993, the indexed-revenue test adjusts dividend and interest revenue for the change in interest rates on Treasury securities since September 1989. The indexed-revenue test was to be applied prospectively (from the first 1993 calendar quarter forward). On February 23, 1993, the Board issued a supplement to its earlier order, indicating that if a section 20 subsidiary had the duration data available to begin measuring compliance with the test on an eight-quarter rolling-average basis immediately, it could do so after notifying its Federal Reserve Bank.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
2190.0.5	2190.0.5	This section was revised to include a summary of a supervisory policy statement on securities activities adopted by the Board. The discussion focuses only on that portion dealing with mortgage-derivative securities products.
2250.0.3.2	2250.0.3.2	This subsection has been revised to reflect a 1992 change in report-submittal instructions. The FR Y-6A report, Bank Holding Company Report of Changes in Investments and Activities, must be submitted to the appropriate Reserve Bank within 30 calendar days of a reportable transaction.
3185.0	3185.0	This section was revised to reflect a FDICIA amendment (the Oakar II Amendment) that permits the merger of a savings association with a Bank Insurance Fund (BIF) member outside the holding company system.
3500.0	3500.0	This section, dealing with tie-in arrangements, has been further revised based on SR-82-41.
3600.8		This new section discusses a Board order authorizing a foreign bank holding company and its wholly owned subsidiary, a commercial banking organization, to engage de novo in various non-banking activities, including an activity that was not previously approved by the Board—engaging in securities credit activities that include acting as a conduit or intermediary in securities borrowing and lending.
4030.0.2	4030.0.2	This subsection was revised to include the required written risk assessment of each active nonbank subsidiary, addressing specified financial and managerial concerns. This requirement was included as part of the supplementary guidance issued for the inspection of nonbank subsidiaries of BHCs, as set forth in SR-93-19.
4060.3.5.2.3	4060.3.5.2.3	This subsection has been revised based on an interim rule (effective December 29, 1992) and a final rule (effective April 26, 1993), amending the risk-based measure of the capital adequacy guidelines. Loans involving one- to four-family residential properties now include loans to builders involving substantial project equity for the construction of such residences, subject to certain qualifying criteria. The risk weight on loans to finance the construction of one- to four-family residences that have been presold has been lowered from 100 to 50 percent. The interim rule implements section 618(a) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRIA).

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
4060.3.5.3.1	4060.3.5.3.1	This section has been revised to include modifications (effective December 30, 1992) of the Board's risk-based capital guidelines involving transactions collateralized by cash. The risk weight was lowered from 20 percent to zero for certain transactions that are collateralized by cash and OECD central government securities, provided the transactions meet specified criteria.
4060.4	4060.4	This section has been revised to limit the discussion to the leverage measure of the capital adequacy guidelines for BHCs.
5000.0.4.4		This new subsection sets forth supplementary guidance regarding the on-site BHC inspection and the off-site review of BHC non-bank subsidiaries, as found in SR-93-19.
5000.0.11	5000.0.11	This subsection has been added to reflect the adoption of a maximum 60-calendar-day completion standard for inspection reports (SR-93-4).
5010.2	5010.2	The confidentiality statement on the cover of the inspection report has been revised in accordance with SR-93-9.
5010.7	5010.7	This section was revised to incorporate into the inspection report, as part of the "Analysis of Financial Factors" page, a combined risk assessment of the inspected BHC's nonbank subsidiaries (SR-93-19).
5010.31	5010.31	This revised section includes the requirement that examiners prepare a written risk assessment of each nonbank subsidiary, as set forth in SR-93-19. The risk assessment is to be documented on the "Nonbank Subsidiary" page of the inspection report or on another equivalent workpaper.
5030.0	5030.0	The "Nonbank Subsidiary" page of the inspection report has been revised to include a risk assessment, in accordance with SR-93-19.

## FILING INSTRUCTIONS

<i>Remove</i>	<i>Insert</i>
	Protector sheet with checklist for supplements
Title page	Title page
1010.0, pages 11 through 14 pages 27 and 28 pages 31 through 40	1010.0, pages 11 through 14 pages 27 and 28 pages 31 through 40
2010.2, pages 1 through 4	2010.2, pages 1 through 5
2050.0, pages 1 through 9	2050.0, pages 1 through 9

<i>Remove</i>	<i>Insert</i>
2130.0, pages 19 and 20 page 27	2130.0, pages 19 and 20 page 27
2185.0, pages 1 through 8 pages 23 through 26	2185.0, pages 1 through 8 page 8.1 pages 23 through 26
2190.0, pages 1 through 8	2190.0, pages 1 through 9
2190.1, pages 1 through 4	2190.1, pages 1 through 4
2250.0, pages 1 and 2	2250.0, pages 1 and 2
3000.0, pages 9 and 10	3000.0, pages 9 and 10
3185.0, pages 1 and 2	3185.0, pages 1 and 2
3500.0, pages 1 through 3	3500.0, pages 1 through 4
	3600.8, pages 1 and 2
4030.0, page 1	4030.0, pages 1 and 2
4060.3, pages 1 through 24	4060.3, pages 1 through 26
4060.4, pages 1 through 3	4060.4, pages 1 and 2
5000.0, pages 5 and 6	5000.0, pages 5 and 6 pages 6.1 and 6.2 page 15
5010.2, pages 1 and 2	5010.2, pages 1 and 2
5010.7, pages 1 and 2	5010.7, pages 1 and 2
5010.14, pages 1 and 2	5010.14, pages 1 and 2
5010.31, page 1	5010.31, page 1
5030.0, pages 37 and 38	5030.0, pages 37 and 38
6000.0, pages 1 through 6 pages 19 through 26 pages 33 and 34 pages 37 and 38 pages 41 through 47	6000.0, pages 1 through 6 pages 19 through 26 pages 33 and 34 pages 37 and 38 page 41 through 47

# Bank Holding Company Supervision Manual

## Supplement 3—December 1992

This revised manual comprises the third revision of the Bank Holding Company Supervision Manual. It represents an updating of the Bank Holding Company Supervision Manual by the Division of Banking Supervision and Regula-

tion for the period of July 1991 to December 1992. The revision includes decisions of the Board of Governors, new and revised statutory and regulatory changes, and other items of a supervisory nature.

### LIST OF CHANGES

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
2010.0.1	2010.1.1	The Board's Source of Strength Policy has been moved to this subsection for the general supervision of subsidiaries.
2010.0.2		This subsection was revised to include a discussion of the Board's denial of a December 1991 BHC request to waive any requirement of the Board that it serve as a source of financial strength to the subsidiary bank (the Board's "Source of Strength" policy).
2010.2	2010.2	<p>This loan administration section, as it pertains to a BHC's supervision of subsidiaries, has been revised to include the supplementary guidance on real estate loans provided by SR 91-16 (July 1991). Sound lending policy components items 11 and 12 have been expanded with regard to the establishment, monitoring, and assessment of policies that control risk from asset concentrations. It also discusses the administration of real estate construction and mini-perm loans.</p> <p>In addition, sound lending policy component item 14 was revised to encourage management to dictate appropriate guidance as to the extent of overall disclosure of past due (nonaccrual) loans. Item 15 was also revised to include March 1991 guidance on using a comparison of the Allowance for loan and Lease losses to loans classified substandard.</p>
2010.5		The new section discusses the liability associated with clean-up of hazardous substance contamination as it relates to the Comprehensive Environmental Response, Compensation and Liability Act. The Act addresses the problem of proper handling and disposal of hazardous substances. Reference: SR 91-20.
2020.5.4	2020.5.4	This section was amended to include a reference to the Board's December 1990 amendment of Regulation H for the payment of dividends by state member banks.
2020.6	2020.6	Section was amended with a provision of FDICIA as to the assessment of management fees that would result in a financial institution being undercapitalized.
2030.0.2		This new subsection has been added to discuss the two year extension for engaging in nonbanking activities and controlling voting securities or assets of a nonbank subsidiary (section 225.33(e) of Regulation Y).

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
2030.0.5	2030.0.5	This subsection, relating to the expansion of grandfather activities, was revised with regard to the discussion on Appendix 1 relating to the acquisition of assets. The criteria for a permissible purchase of an asset in the “ordinary course of business,” as stated in an interpretation of Regulation Y, section 12 C.F.R. 225.132, was revised by the Board, effective June 29, 1992. The criteria for determining whether an acquisition of nonbank assets would be presumed to be significant, based on the book value of nonbank assets being acquired, was changed from 20 to “. . . 50 percent of the book value of the nonbank assets of the holding company or nonbank subsidiary comprising the same line of activity.”
2060.1	2060.1	This section was revised to instruct examiners to consider the size of audit staffs of peer banking organizations when evaluating the effectiveness of an internal audit program.
2060.1.4	2060.1.4	This revised subsection includes additional inspection procedures addressing the review of audit scope, audit scope limitations, the extent of reliance on internal audit staff by external auditors, and the independence of the external auditors including any potential conflicts of interest.
2065.1		A new section has been added to provide guidance dealing with disclosure, accounting, and reporting issues relating to nonaccrual loans and restructured debt. The discussion incorporates the July 1991 (SR 91–16) guidance that was issued to supplement the March 1, 1991 joint Federal bank and thrift regulatory agency statement that clarified certain supervisory and accounting policies.
2065.2		This new section relates to the need for management to apply fully documented and consistent methods of determining the adequacy of the allowance for loan and lease losses. The section discusses factors to consider in determining the outstanding amounts of this valuation allowance. Guidelines are also provided that the examiners should observe when they evaluate the adequacy of the allowance and the methods used to determine the account balance. Inspection objectives and procedures are included.
2070.0	2070.0	This revised section includes a general discussion of the new accounting standard for income taxes (FASB Statement No. 109) with respect to deferred tax assets. The revision also conveys the Federal Reserve’s position that implementation of this new standard should not occur for reporting purposes (with the Federal Reserve) until a final evaluation is completed and further notice is given. The schedule of deadlines and due dates for tax estimate payments and filing extensions has been updated.
2090.0	2090.0	This section was revised to reflect the current provisions of Regulation Y as to the rebuttable presumptions of control.



<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
2090.1	2090.1	This change in control section has been revised to reflect FIRREA provisions. Of particular note are the statutory corrective action measures that may be used for violations of the Change in Bank Control Act.
2090.2	2090.2	This section was revised to reflect the capital requirements for small one-bank holding company formations found in Appendix C of Regulation Y. Additional explanatory narrative is provided, discussing, from a historical perspective, how revisions to the capital adequacy guidelines have been applied to the policy statement. The benefits of filing a consolidated tax return for the bank holding company are briefly discussed.
2090.3	2090.3	This section was revised to reflect the current provisions of Regulation Y for treasury stock redemptions. This includes the Board's November 9, 1990 revision of Regulation Y to not require notices if regulatory clearance had already been received to acquire 10 percent or more of the voting shares of a state member bank or bank holding company, and subsequent ownership resulted in treasury stock redemptions of between 10 and 25 percent. Clarification has been provided as to when SEC registration is required under the 1934 SEC Act. The inspection procedures have been expanded to alert examiners as to treasury stock redemption practices that may result in the undermining of the banking organization's capital position.
2090.4	2090.4	This section was revised to add references for the discussed policy statement.
2090.5	2090.5	Section was revised to reflect the current provisions of section 225.12 of Regulation Y (transactions not requiring Board approval).
2090.6	2090.6	This section on divestiture control determinants was revised to reflect the current structuring of Regulation Y and to include additional references in subsection 2090.6.3.
2090.7	2090.7	Subsection 2090.7.1 was revised to include footnote no. 1 discussing FIRREA provisions that prohibit allowing an affiliate of a nonbank bank or industrial bank to incur overdrafts at the bank or Federal Reserve Bank. Subsection 2090.7.2 was added to provide respective references.
2100.0	2100.0	This section on foreign banking organizations was revised to reflect FDICIA's amendment of the International Banking Act of 1978. The Federal Reserve's authority over foreign bank operations (including representative offices in the U.S.) was increased.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
2130.0	2130.0	This section has been revised to reflect current operational activities and terms that would be encountered in the futures, forwards, and options markets. The section has been expanded to include a discussion of option and other derivative financial contracts such as calls, puts, caps, floors, and collars. Various hedging and other contract strategies are also reviewed.
2175.0		Section incorporates examiner guidelines (SR 91–14) for reviewing the sale of uninsured annuities by BHCs and banks that have legal authority to act as agent in their sale.
2185.0	2185.0	The section has been revised to provide additional section 20 company inspection procedures and definitive guidance with regard to: 1) customer complaint files; 2) the gross revenue test; 3) extensions of credit and purchases and sales of assets; 4) the review of service agreements with affiliates; 5) making a market in securities; 6) directors of subsidiary banks serving as directors of a section 20 subsidiary; 7) the placement of advertising materials for a section 20 subsidiary in affiliated bank subsidiaries; 8) issues dealing with corporate separateness and measures that should be taken to avoid customer confusion as to the non-federally insured status of a section 20 subsidiary; 9) the section 20 subsidiary serving as agent for a bank or thrift affiliate; 10) bank officer bonuses versus section 20 subsidiary activities; 11) a section 20 subsidiary's purchase of syndicate securities from another syndicate member; 12) a section 20 subsidiary engaging in repurchase and reverse repurchase agreements with respect to U.S. Treasury securities with a foreign subsidiary of an affiliated bank; 13) revenue classification with regard to "loans" versus "securities"; 14) the SEC's RULE 144A (safe harbor exemption from the 1933 Act for restricted securities that are sold in the "private placement" market to qualified "institutional buyers);" and 15) entering bid or ask quotations or publishing "offering wanted" or "bid wanted," notices on trading systems other than an exchange or NASDAQ.
2190.1		This new section discusses credit supported and asset-backed commercial paper (SR 92–11). Along with a description of such programs, the policies and procedures that the banking organization should have for such a program are discussed. Included with the section are guidelines relating to the risk-based capital treatment for such programs. Inspection objectives and procedures are also provided.
	2230.0	The December 1987 Supervisory guidelines for real estate appraisal policies and review procedures have been removed from the manual. They have been replaced by the Board's September 1992 Guidelines for real estate appraisal and evaluation programs, now found in Appendix A of manual section 2231.0.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
2231.0		This new section discusses provisions of Title IX of FIRREA as to real estate-related financial transactions requiring the services of an appraiser. Appraisals must be in writing and be prepared in accordance with uniform standards and be performed by individuals with demonstrated competency. The section discusses the Board's appraisal regulation (see Manual section 3270.0) and the need for banking organizations to adopt appraisal and evaluation policies. The Board's guidelines for real estate appraisal and evaluation programs are included in Appendix A.
2240.0	2240.0	This former section on "Guidelines for the Review and Classification of Troubled Real Estate Loans" has been revised to incorporate additional Examiner guidance resulting from the November 1991 interagency policy statement on the "Review and Classification of Commercial Real Estate Loans" (SR 91-25).
3000.0	3000.0	Appendix 1 has been revised to add the Board's April 22, 1992 approval of higher residual value leasing, the provision of full service brokerage services for institutional and retail customers, and certain financial advisory activities for inclusion on the Regulation Y permissible nonbanking activities "laundry list". Appendix 2 has been amended to include additional Board actions disseminated by Board order. Appendix 3 was amended to include the Board's January 9, 1991 denial of a request by three BHCs to engage in clearing securities options and other financial instruments for the accounts of professional floor traders.
3130.2	3130.2	Section was revised to reflect current tax treatment for REITs and to discuss their funding and their various types.
3130.4	3600.12	These sections were relocated and amended as the result of the Board's adding the provision of full service securities brokerage to section 225.25(b)(15) of Regulation Y, effective September 10, 1992.
3130.5	3600.25	
3130.6	3600.35	
3130.7	3600.41	
3140.0	3140.0	This section has been revised to incorporate the Board's April 1992 adoption of higher residual value leasing as a nonbanking activity authorized for BHCs under section 225.25(b)(5) of Regulation Y. The section also has been revised to include current accounting guidance for lessors and lessees for operating and capitalized leases.
3230.1	3600.22	These sections were relocated and amended to accommodate the Board's adding of the advisory nonbanking activities to section 225.25(b)(4) of Regulation Y, effective September 10, 1992.
3230.2	3600.32	
3230.3	3600.42	
3240.0	3240.0	The introduction was revised to recognize section 20 subsidiary nonbanking activities. Subsections 3240.0.7.2 and 3240.0.12 have been revised to incorporate references to section 23B of the Federal Reserve Act.
3250.0.7	3250.0.7	Added a reference to section 23B of the FRA to FCM inspection procedure 6.c.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
3500.0.6		This new subsection provides an inspection checklist for ensuring compliance with the prohibitions against tying arrangements. The checklist addresses written policies and procedures, training, and audit procedures.
3510.0	3510.0	This section has been revised to reflect provisions of the Board's Regulation K as of April 8, 1992, as it pertains to nonbanking activities of foreign banking organizations (12 C.F.R. 211.24).
3550.0	3550.0	This revised section includes a general discussion of requirements and limitations for U.S. banking organizations investing in or engaging in foreign banking activities. The section includes brief discussions of amendments to Regulation K by the Board that were effective May 24, 1991, expanding the scope of international activities. The Board expanded the existing authority to: 1) to engage, after March 27, 1991, with the Board's approval, in underwriting and dealing in equity securities outside the U.S.; 2) increase the current dollar limits under which U.S. banking organizations may make investments abroad without prior notice to the Board; 3) clarify the portfolio-investment authority under which U.S. banking organizations may make limited equity investments in any type of company outside the U.S.; 4) expand the range of permissible activities for U.S. banking organizations abroad to include futures commission merchant activities and life insurance underwriting; 5) modify the authority for debt-for-equity investments; and to 6) authorize case-by-case exemptions from the standard for qualifying banking organizations.
3560.0	3560.0	The discussion of section 23A of the FRA was amended to include section 23B of that Act. Subsection 3560.0.1.1 (item 7) was also amended with this change.
3600.5	3600.5 3600.8	The previous sections were combined for nonbank activities involving foreign branches.
3600.6.4		A new subsection discusses the Board's July 1991 order authorizing the applicants to trade, through a wholly owned nonbanking subsidiary, in futures, options, and options on futures (derivative instruments) that are based on U.S. government bank-eligible securities and certain money market instruments.
3600.6.5	3600.43 3600.47	These former sections were combined with Manual section 3600.6. The section was expanded to also include brokering, dealing, and specializing in options.
3600.7	3600.7 3600.44	These former sections were combined into one section for broker-dealer services.
	3600.9	This former section was deleted and reserved for future use.
3600.11	3600.12	Section was renumbered.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
3600.12	3600.13 3600.20 3600.23 3600.34	These former sections were combined into one section for payment instruments.
3600.13	3600.14 3600.15	These former sections were combined into one section for FCM brokerage of securities.
3600.14	3600.17	This section was renumbered.
3600.15	3600.18 3600.37	These former sections have been combined into one section for consulting services.
3600.15.3		This new subsection discusses the Board's authorization for two BHCs to provide through a nonbank subsidiary, management consulting services to governmental agencies (i.e. FDIC and the RTC) and unaffiliated financial institutions with troubled assets.
3600.16	3600.19	Section was renumbered.
3600.17	3600.21 3600.39	These former sections have been combined into one section for insurance nonbanking activities.
3600.18	3600.26 3600.38 3600.51	These former sections were combined into one section for investment advice.
3600.20	3600.27	Section was renumbered.
3600.19	3600.24 3600.45	These former sections were combined into one section for private placement and riskless principal nonbanking activities.
3600.21	3600.28 3600.29 3600.30 3600.40	These former sections were combined into one section for underwriting and dealing nonbanking activities.
	3600.31	This former section was deleted.
3600.22	3600.33	These sections were renumbered.
3600.23	3600.36	
3600.24	3600.49	
3600.25	3600.48	
3600.26	3600.50	
3700.2	3700.3 3700.9 3700.10 3700.11 3700.14	These former sections are combined into one section for impermissible insurance activities.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
3700.3	3700.4	These sections were renumbered.
3700.4	3700.5	
3700.5	3700.6	
3700.6	3700.8	
3700.7	3700.12	
3700.8	3700.13	
3700.9	3700.15	
3700.10	3700.16	
3700.11	3700.17	
3700.12		
		This new section discusses the Board’s January 1991 denial of an application to engage, through a wholly owned subsidiary, in clearing securities options and options on other financial instruments for the accounts of professional floor traders. One issue centered on plans to provide only clearance services, rather than execution and clearance services where risk could be better controlled. Another issue centered on the absence of an effective means to monitor and limit the potential credit risk exposures to the parent bank holding company resulting from transactions initiated by professional floor traders.
4010.0	4010.0	This section was revised to reflect the April 1990 single inspection report format per SR 90–13 and to incorporate risk-based capital changes. Subsections 4010.0.3 and 4010.0.7 were amended to recognize Tier 1 capital instead of primary capital.
4020.1	4020.1	This section has been revised to recognize the risk-based and leverage bank capital measures of the capital adequacy guidelines. The examiner must analyze the adequacy of bank capital based on the guidelines. The examiner is referred to section 303.1 of the <i>Commercial Bank Examination Manual</i> for further guidance.
4020.3	4020.3	This section was revised to reflect the Boards amendment of Regulation H (section 208.19), as it pertains to the payment of dividends by state member banks.
	4020.6	This section was deleted.
	4060.2	This former section has been deleted. It represented the capital adequacy guidelines based on primary, secondary, and total capital.
4060.3.2.1	4060.3.2.2	These subsections were revised based on the Board’s January 14, 1992 lifting of the limit on the amount of noncumulative perpetual preferred stock that BHCs may include in Tier 1 capital for the purposes of calculating their risk-based and Tier 1 leverage capital ratios.
4060.3.6.1	4060.3.6.2	

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
4060.3.2.1.1.1		This subsection was added to reflect the Board's view that common equity should remain the dominant form of a banking organization's capital structure, as stated in its January 14, 1992 amendment to the risk-based and Tier 1 leverage capital measures. The situation is discussed when banking organizations are deemed to clearly have an overreliance on nonvoting equity elements in Tier 1 capital.
4060.3.2.1.1.2		This new subsection discusses perpetual preferred stock that is convertible to common stock. Generally such preferred stock is not included in Tier 1 capital.
4060.3.2.1.1.3		This new subsection states that excess minority interests in the form of a subsidiary's preferred stock would usually be excluded from capital.
4060.3.5.2.4		This new subsection is added to address the treatment of residential mortgages sold with recourse that are not already included on the balance sheet. Such assets are to be converted at 100 percent and assigned to the highest risk weight appropriate to the obligor or the nature of any collateral or guarantees. An exception applies to transfers of pools of residential mortgages.
4060.3.5.3.3	4060.3.5.3.2	This revised subsection discusses the zero conversion factor capital requirements for commitments that expire within one year but are subject to renewal (under a six to eight week renegotiation period).
4060.3.5.3.7		This subsection discusses the capital treatment of assets sold with recourse. Capital must be held against such assets when any risk of loss is retained.
4060.3.5.4.2		This subsection sets forth qualification criteria for subordinated debt of a BHC to be included in Tier 2 capital (Ref: SR 92-37). Also discussed, is the Board's August 28, 1992 Regulation Y interpretation that sets forth the criteria that subordinated debt must meet to be included in capital. The section refers to certain events, default clauses, or terms that could prevent subordinated debt from being included in capital. Certain acceptable terms are also included.
4060.3.6.2		This subsection discusses certain terms that may or <i>may not</i> qualify perpetual preferred stock for Tier 1 capital treatment.
4060.3.7	4060.3.7	This section was revised to include the Board's October 4, 1991 revision (effective November 7, 1991) to paragraph II.A.1.b. of the risk-based measure of the capital adequacy guidelines. The provision provides that any perpetual preferred stock with a feature permitting redemption at the option of the issuer qualifies as capital <i>only if</i> the redemption is subject to prior approval by the Federal Reserve.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
4060.3.9	4060.3.9	This subsection was revised to include the 12 CFR 225, appendix B criteria for mandatory convertible debt securities and perpetual debt for inclusion as Tier 2 capital in the risk-based capital measure as referenced in section II.A.2.c. of the risk-based capital guidelines.
4060.3.9.1 4060.3.9.2		These subsections have been added based on the Board's August 18, 1992 interpretation of Regulation Y with regard to the limitations on the amount of subordinated debt that is to be included in Tier 2 capital. These sections discuss the capital treatment of such debt with dedicated proceeds or segregated funds.
4060.3.9.3	4060.2.3.5.1	This subsection was added to include the 12 CFR 225, appendix B criteria applicable to both types of mandatory convertible securities for inclusion as Tier 2 capital, as referenced in section II.A.2.c. of the risk-based capital guidelines.
4060.3.9.3.1	4060.2.3.5.2	This new subsection includes the additional criteria applicable to equity contract notes referenced in the risk-based capital guidelines, as described above.
4060.3.9.3.2	4060.2.3.5.3	This new subsection includes the additional criteria applicable to equity commitment notes referenced in the risk-based capital guidelines, as described above.
4060.8	4060.8	This section was revised to reflect the Board's February 1992 phasing out of the use of the formal HLT definition. The action was taken on an interagency basis (with the OCC and the FDIC). The formal definition had accomplished its original objectives of focusing attention on the need for internal controls and review mechanisms for monitoring and structuring HLTs, in a manner consistent with the associated risks. The revised section continues, and does not change, the general responsibilities of banking organizations for administering HLTs, the methods of HLT financing, and the HLT inspection guidelines and considerations.
4070.0.8	4070.0.8	This subsection was revised to make reference to the risk-based and leverage capital measures, discussed in more detail in sections 4060.3 and 4060.4. The section also acknowledges the September 18, 1992, issuance of final Prompt Corrective Action Measures for state member banks, as a result of FDICIA.
4090.0	4090.0	The section was revised to reflect the change from semiannual to quarterly reporting on the Country Exposure Report (Form FFIEC 009).
5000.0.1	5000.0.1	This subsection, representing the general instructions for the BHC inspection program, has been revised to incorporate Board and System Task Force changes to inspection reporting by SR 90-13 (April 1990). The inspection report was condensed to one basic format for all bank holding companies.



<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
5010.1	5010.1	This section has been revised to indicate that the inspection report now consists of a Core section and a Confidential section. Additional supporting schedules are to be added to the open section when an existing area of concern or problem is addressed within the report. The section lists report pages that are to be included in the Core section of the inspection report for BHCs under or over \$150 million or more in consolidated or total assets, as applicable. Also discussed are new or revised report pages that have been added to the confidential section (i.e. Liquidity and Debt Information and Administrative and Other Matters). A list of supporting report pages is also included.
5010.3	5010.3	The Table of Contents report form has been revised to list the core pages to be included in the report. Supporting report pages follow the core pages.
5010.4	5010.4	The Examiner's Comments instructions have been revised to indicate that the BOPEC financial composite rating is to be stated (SR 88–37).
5010.5	5010.5	The instructions for the Scope of the inspection were revised for identifying peer groups and for inclusion of source information as to the administration of policies and supervision over subsidiaries. The examiner is also to comment on the extent of reliance on internal or other regulatory agency classifications.
5010.6	5010.13	This revised report page and instructions for "Structure and Abbreviations" replaces the former "History and Structure" page. The instructions have been amended to include the April 1990 revisions of SR 90–13.
5010.7	5010.7	The consolidated portion of the instructions for the Analysis of Financial Factors core page have been amended to include an analysis of asset quality and the adequacy of valuation reserves. Subsection 5010.7.5 provides for the use of an alternate format for the analysis of financial factors for larger and more complex bank holding companies.
5010.10	5010.10	This section provides the form and instructions for the "Summary of Consolidated Criticized Assets and Other Transfer Risk Problems" set forth in SR 90–13 and revised for risk-based capital by AD 91–25. The form replaced the "Summary of Examiner's Classifications of Parent Company and Nonbank Subsidiary Assets" report page. The new form is to contain, by BHC organizational level, information and methods used by the examiner for determining consolidated asset quality. The report page summarizes criticized or classified assets, off-balance sheet risk (listed separately) and other transfer risk problems. Subsection 5010.10.1.1.1 includes the September 1981 (SR 91–18) classification guidelines for an asset when a substantial portion of the asset has been charged-off.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
5010.10 continued	5010.10 continued	The reporting instructions have been revised as to the weighted classified asset treatment of “value impaired” assets. In accordance with SR 92–2, value impaired classifications are now weighted the same as substandard classifications at 20 percent. Previously, these assets were weighted the same as “doubtful” classifications at 50 percent, net of the allocated transfer risk reserves (ATRR).
5010.13	5010.32	The “Capital Structure” report page and instructions have been revised to reflect the capital adequacy guidelines based on the risk-based measure and the Tier 1 leverage measure. The report forms were derived from AD 91–25. The instructions are split between BHCs with consolidated assets of \$150 million or more and those with a lesser amount, whereby the FR 1241 report form is used for the lead bank or comparable bank subsidiary(ies).
5010.13	5020.21	The “Capital Structure” (FR 1241) report page and instructions have been revised to reflect the capital adequacy guidelines based on the risk-based measure and the Tier 1 leverage measure (refer to AD 91–25). The instructions for this report page are included in Manual section 5010.32.
5010.14	5010.6	The “Policies and Supervision” page was revised to include a discussion and appraisal of the parent company’s policies with respect to dividends paid to stockholders.
5010.17	5010.11	The “Classified Assets and Capital Ratios of Subsidiary Banks” report page and instructions have been revised to incorporate changes from revisions to the capital adequacy guidelines—the risk-based measure and the leverage measure.
5010.37		The “Interest Rate Sensitivity—Assets and Liabilities” report page is a new page, accompanied by instructions, that was developed for reporting consolidated interest rate sensitivity based on pre-determined maturity categories.
5010.40	5010.39 5010.40	The “Principal Officers and Directors” confidential report page and instructions represents a condensing of former confidential page A—Principal Officers and former confidential page B—Directors per SR 90–13. For the revised report page, the salary, directors fees and other remuneration, and certain ownership information, was made optional and reserved for inclusion in other supporting schedules.

<i>New Section Number</i>	<i>Previous Section Number</i>	<i>Description of the Change(s)</i>
5010.41	5010.41	The confidential “Condition of the Bank Holding Company” report page and instructions have been revised to include additional ownership information. The review of ownership is to include a determination whether an individual or group of shareholders exercises significant influence over the BHC. Also the fiduciary holdings of the parent company stock are to be discussed. Management comments should include an assessment of the effectiveness and control of supervision over subsidiaries. Comments on risk evaluation and management information systems are also to be included.
5010.42	5010.31	The confidential “Liquidity and Debt Information” report page and instructions were derived from the former “Unaffiliated Borrowings” report page. The revised report page expands certain information on commercial paper borrowings and funding gap for the parent company.
5010.43	5010.42	The “Administrative and Other Matters” confidential page D is the fundamental successor to the former “Other Matters” confidential page. The records checklist and the internal revenue service audit statement have been removed. Space has been provided for suggestions for the next inspection. Planning information can also be provided for on-site work to be performed for the next inspection.
5010.44	5010.43	In accordance with SR 90–13, the former “Statistical Data Sheet” confidential report pages were replaced by the Inspection Summary FR 1417 and FR 1417a. These schedules provide the necessary statistical and other supporting data to give the reader a thorough, yet brief, summary of the financial condition and operations of the BHC. The final summary will comprise the last pages of the confidential section of the report. Reserve Banks can elect to provide the former “Statistical Data Sheet pages” in addition to the FR 1417/1417a.  The inspection summary was revised by AD 91–25 to incorporate changes to the capital adequacy guidelines based on the risk-based measure and the Tier 1 leverage measure.
5020.1	5020.18	The “Bank Subsidiary” (FR 1241) report page and instructions were revised to include the ratio of weighted classified assets to Tier 1 capital plus the allowance for loan losses (ref. AD 91–25).
5030.0		This section contains all inspection reporting forms currently in use. A reference list of the forms is provided.

**The Bank Holding Company Supervision Manual** has been prepared by Federal Reserve supervision personnel to aid in the conduct of on-site inspections of bank holding companies and their nonbank subsidiaries. Through the work of many dedicated field examiners and other supervisory staff, the Manual presents a compilation of formalized procedures and Board policies followed by inspection personnel, and includes new concepts that have been introduced to keep pace with the ever changing BHC industry. The Manual is an integral part of the Federal Reserve's overall program to supervise bank holding companies and enhances the staff's ability to implement the Board's recently intensified on-site inspection effort.

The Manual is designed to provide guidance to examination and supervision personnel. It *should not be considered a legal reference*. Questions concerning applicability and compliance with Federal laws and regulations should be referred to appropriate legal counsel.

Effective January 1, 1986, the Federal Reserve initiated an intensified on-site inspection program for bank holding companies that called for the semi-annual inspection of larger and weaker institutions. This new program formalized the use of limited scope and targeted scope inspections, in addition to the use of full scope inspections.

The new procedures were designed to supplement the Federal Reserve's ongoing monitoring efforts which include frequent communication with the senior management of bank holding companies and review of data contained in various reports filed with the Federal Reserve, the Securities and Exchange Commission, and other regulatory agencies. In this regard, the new policy strengthens and formalizes current practices for communicating the findings of inspections to management and boards of directors when significant problems exist.

The inspection program calls for Reserve Banks to monitor the financial condition of bank holding companies and their nonbank subsidiaries, as well as the transactions that occur between these entities and subsidiary banks. The basic objective of this monitoring is to ascertain whether the strength of the bank holding company is being maintained on an ongoing basis and to determine the impact or consequences of transactions between the parent holding company or its nonbanking subsidiaries and the subsidiary banks.

In measuring financial strength of the bank holding company, the inspection process focuses

on financial indices of both the consolidated entity and its component parts. The principal indices appraised are: quality of assets, earnings, capital adequacy, cash flow and liquidity, and competency of management. Analysis of earnings performance is perhaps the most critical element in the inspection and monitoring process inasmuch as the ability to operate profitably is essential to the continued viability of a bank holding company. The inspection procedures are designed to consider the quality as well as the quantity of earnings. During inspections, examiners review the earnings performance of the individual subsidiaries, and, if necessary, probe behind the figures to determine the root cause of any difficulty. Particular attention is given to the assessment of the adequacy of provisions to the reserve for loan losses covering the nonbank subsidiaries. The examiner is in a position to make such an assessment since a review of the quality of assets in the nonbank subsidiaries as part of his inspection of the holding company has been performed. Overall performance of the holding company is analyzed principally through the use of ratio comparisons with standards of performance and with the performance of other similar bank holding companies. The ability of the bank holding company to maintain an adequate level of capital as well as to preserve its overall ability to act as a source of financial strength to its subsidiaries are primary considerations.

The inspection process utilizes the so-called "building block approach" as a tool for analyzing capital adequacy of bank holding company subsidiaries. This approach generally provides that nonbank subsidiaries of a banking organization should maintain levels of capital consistent with the levels that have been established by industry norms or standards; by Federal or State regulatory agencies for similar firms that are not affiliated with banking organizations, or that may be established by the Board after taking into account risk factors of a particular industry. The assessment of an organization's consolidated capital adequacy must take into account the amount and nature of all nonbank activities, and an institution's consolidated capital position should at least equal the sum of the capital requirements of the organization's bank and nonbank subsidiaries as well as those of the parent company.

Analysis of capital adequacy of the consoli-

dated entity and review of “parent only” leverage is particularly germane when the parent holding company has used the proceeds of borrowings to provide capital for a subsidiary (i.e., double leverage).

This ability to supply capital to its subsidiaries, even if such capital represents proceeds from increased borrowings, provides added flexibility to the total organization. There is, however, a limit to the relative amount of such activity in which a given holding company can or should engage. The market place exerts some restraint on the amount of long-term debt that a bank holding company is able to raise. Statutory constraints on the movement of cash from subsidiary banks to their parent holding companies further limit the long-term debt capacity of most bank holding companies; and the inspection program itself discourages behavior that may be leading toward an overextended financial condition.

During inspections of bank holding companies, examiners develop information necessary to assess the ability of the holding company to comfortably service its outstanding debts. A close analysis of cash flow with emphasis on requirements for debt service and shareholder dividends is one of the most important elements of the new procedures. In the analysis, the examiner pays particular attention to the ability of the bank subsidiaries to maintain adequate capital levels given the cash dividend demands of the parent holding company.

The total amount of dividends a bank may pay to its shareholders, whether or not the shareholder is a bank holding company, is restricted by statute. The amount of credit and the type of collateral necessary to support loans from a bank to the parent holding company and its nonbanking subsidiaries are also governed by statute. These laws are designed to protect banks from abuse by control-owners. In essence, they place limits on ordinary ownership rights in view of the overriding need to maintain the soundness of banks given their key role in the economy and their fiduciary duty to depositors.

Bank holding company examiners, in addition to the enforcement of the above statutes, review intercompany transactions to determine if they result in a diversion of income or income opportunity from the bank to the bank holding company. The most common transactions of this type that occur between a bank and its parent holding company involve either remuneration for services rendered to the bank by the bank

holding company or intercorporate tax transactions. In the overwhelming majority of cases, such remunerations involve payment of fees for items such as data processing or audit services, and are entirely appropriate. However, on occasion, payments represent transfers that should more properly be treated as loans or dividends, and the banks are disadvantaged.

To ascertain whether such remunerations are proper, examiners review management fees paid by banks to their holding company affiliates in relation to services rendered; and examiners will criticize management fees that appear to be excessive and to be used merely as a device for moving cash from a bank to a bank holding company. Occasionally, banks maintain balances with other lending institutions to support the borrowings of their parent holding company or a sister subsidiary. In such instances, the examiner is instructed to determine if the bank has been adequately compensated for the use of its funds. He is also instructed to assess the effect of this use of funds on the bank's liquidity position and its ability to serve its community.

To meet the unique responsibility of the Federal Reserve in administering the Bank Holding Company Act, examiners also check for compliance with provisions of the Act and applicable regulations. For example, activities of bank holding companies are reviewed to determine permissibility and to determine if required authorization to engage in such activities has been obtained.

The competency of bank holding company management is, of course, reflected in all of the previously mentioned indices and practices. By bringing these elements together, the bank holding company inspection process provides a vehicle for a comprehensive assessment of the effectiveness of bank holding company management. It also results in a more open and informed dialogue between bank holding company management and representatives of the Federal Reserve.

In summary, the inspection process is intended to increase the flow of information to the Federal Reserve System concerning the soundness of bank holding companies. This information will permit the Federal Reserve to discourage inappropriate or unsound practices and will hopefully eliminate the need for an extensive codification of rigid safety and soundness regulations for bank holding companies.

This Manual will be updated periodically to reflect current supervisory policy and procedures and changing practices in the industry. Accordingly, we solicit the input and contribution of all supervisory staff and others in the

refining and modification of its contents. Please address all correspondence to: Director of Banking Supervision and Regulation, Board of Gov-

ernors of the Federal Reserve System, Washington, D. C. 20551.

# General Table of Contents

## Bank Holding Company Supervision Manual

1010.0

This general table of contents lists the major section heads for each part of the manual:

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1020.0.1 INTRODUCTION

This manual is designed to aid personnel of the Federal Reserve System in supervising bank holding companies. As such, it will review in considerable detail current policies and procedures for supervising the financial affairs of these banking organizations and will also discuss statutes, regulations, interpretations and orders that pertain to bank holding company supervision. Before proceeding, however, it is desirable to step back and view bank holding companies and their supervision in a broader perspective. This preface is designed to provide that perspective.

While the holding company form of organization exists in many industries, it is particularly prevalent in the regulated industries—telephone, electric and gas utility, railroad, savings and loan, and banking. Regulated industries have learned that a holding company structure allows certain entities to avoid some of the constraints of regulation. For example, regulation often limits the geographic area that a regulated firm can serve. By forming a holding company, many regulated organizations can serve a broader area, thereby potentially benefiting from economies of scale and risk reduction through geographic diversification.

A second purpose for the use of a holding company structure by regulated firms is to expand into other product markets, often ones that are not subject to regulation.

A third purpose for the use of a holding company structure is to increase the organization's financial flexibility, thereby avoiding some of the financing constraints imposed by regulation. These constraints can include limitations on leverage, the types of assets that the firm can acquire and the types of liabilities that it can issue. Another possible financial advantage of the holding company is to obtain tax benefits.

Bank holding companies were created for essentially the same reasons that holding companies were created in other industries; to expand geographically, to move into other product markets, and to obtain greater financial flexibility and tax benefits. The primary use of the bank holding company device prior to the late 1960's was to expand banking operations geographically. The holding company form was needed because many States either prohibited or sharply curtailed branching within the State. Moreover, banks generally did not have the authority to branch beyond the geographic limits of the State in which the bank was chartered. By employing

the holding company form of organization, several banking organizations had succeeded by the 1950's in expanding over an entire region of the country, operating banks in several States.

During the 1960's many banks, especially the largest ones, desired to expand into new lines of activity. In most cases, these new activities were financial in nature and were closely related to traditional banking operations. While some banks were successful in obtaining supervisory approval to enter certain of these new activities, the courts subsequently voided many of these approvals. Unable to enter these activities as a bank, many of these organizations converted into the holding company form and entered these activities through the holding company.

In recent years banking organizations also have used the holding company device to increase their financial flexibility. For example, in order to avoid the reserve requirements and interest rate ceilings applicable to deposits of their bank subsidiaries, many banking organizations have utilized the parent company as a vehicle to fund the organization. Moreover, the holding company structure has allowed organizations to attain higher leverage levels than otherwise might have been permitted.

Historically, the Bank Holding Company Act sought to provide for the separation of banking from commerce. In order to avoid any detrimental effects on the public interest, the activities of bank holding companies have been limited by law and regulation and transactions with banking subsidiaries are virtually prohibited. This basic rationale is the cornerstone for regulating the financial affairs of bank holding companies.

### 1020.0.2 POSSIBLE CONSEQUENCES OF HOLDING COMPANY FORMATION

There are two primary ways that a holding company can have an adverse effect on the financial condition of a regulated subsidiary. The first is for the holding company (or its unregulated-regulated subsidiaries) to take excessive risks and fail. This failure could have a "ripple effect" on the regulated firm, impairing its access to financial markets. The classic case is the Insull empire in the electric utility industry, which involved the pyramiding of numerous highly leveraged holding companies. The col-

lapse of this pyramid during the Depression of the 1930's severely impacted the regulated electric utility operating companies and impaired their ability to service the public.

A second major way that a holding company can have a harmful effect on the financial condition of a regulated subsidiary is through adverse intercompany transactions and excessive dividends. Adverse intercompany transactions typically involve either the purchase and sale of goods and services or financial transactions that are on nonmarket terms. Concern over the use of the holding company device to transfer financial resources from the regulated firm has been particularly prevalent. In this case, there has been a conflict of views between the government, and the firms which want to diversify in order to increase their return on investment.

In the mid 1970's, concern over holding companies forcing regulated firms into adverse transactions surfaced in the banking industry. In this instance, the objective was not to divert resources from the bank to more profitable areas, but rather to use bank resources to save a non-bank affiliate from failure.

### 1020.0.3 REGULATORY RESPONSE TO THE HOLDING COMPANY

Historically, public policymakers have recognized that holding companies can have both positive and negative effects on regulated subsidiaries. The fact that policymakers have permitted holding companies to exist in all of the major regulated industries indicates that the effects, on balance, have not been decidedly negative. However, there have been enough problems over the years that holding companies in most regulated industries are subject to at least some form of regulation. This regulation varies substantially from one regulated industry to another.

Until the mid-1970's, Congressional concerns with bank holding companies were primarily oriented to competition, concentration of financial resources and the proper range of banking activities. However, there was also some limited recognition of the possible impact of holding companies on the financial condition of banks. The earliest evidence was the Banking Act of 1935, in which Congress gave the Federal Reserve Board authority to issue permits to holding companies to vote the stock of their banks. In acting on permit applications, the Board was required

to consider the holding company's financial condition, the character of its management, and the effect of granting the permit on the bank. Congress also gave the Federal Reserve the right to inspect bank holding companies.

About two decades later, Congress passed the Bank Holding Company Act of 1956. This legislation required the Federal Reserve, in passing on proposed bank acquisitions by holding companies, to consider the competitive, financial and managerial implications of the proposal. More recently, the Bank Holding Company Act Amendments of 1970 required the Federal Reserve to make a similar determination in applications by holding companies to acquire nonbanking companies. The amendments also brought one-bank holding companies into the Federal Reserve's jurisdiction.

Subsequently, Congress and the public became seriously concerned over the possible adverse impact of holding companies on the financial condition of subsidiary banks. These adverse developments led to two results; additional legislation and stepped-up holding company supervision. The major Congressional action was to give the Federal Reserve much needed cease and desist powers over bank holding companies. This authority now supplements certain statutes, such as dividend restrictions and limitations on bank transactions with affiliates, that tend to protect banks in a holding company organization.

In the mid-1970's, the Federal Reserve stepped up its supervision and monitoring of bank holding companies in a variety of ways. First, the Federal Reserve increased the scope and frequency of holding company inspections, and later introduced a bank holding company rating system designed to focus attention on those organizations having the most serious problems. Second, the Federal Reserve began to monitor transactions between bank subsidiaries and the rest of the holding company organization through quarterly intercompany transactions reports. Third, the Federal Reserve implemented a computer-based surveillance program designed to identify emerging financial problems. Finally, the Federal Reserve began to employ its new holding company cease and desist powers in an effort to curtail unsafe and unsound practices.

The period prior to 1980 marked a gradual decline in the ratio of equity capital to total assets within the United States Commercial banking system, particularly for the nation's largest banking organizations. In an effort to reverse that trend, the Federal Reserve System and the Comptroller adopted guidelines for

national and state member banks and bank holding companies in December 1981. The guidelines established minimum capital levels and capital zones. The guidelines provided state member banks and bank holding companies with targets or objectives to be reached over time. As a result, many of the banks and bank holding companies improved their capital positions. However, other developments, including deregulation of interest rates on bank liabilities, weakening of loan portfolios (asset quality) of some banking institutions occasioned by economic shocks in certain industries or geographical areas, and increased competition in the financial services areas, combined to place additional pressures on the profitability of banking institutions and accentuate the potential demands on the capital positions of those institutions.

The Federal Reserve System continued to stress the importance of the capital guidelines in setting standards of capital adequacy. The Board thus amended its guidelines in June 1983, to set explicit minimum capital levels for multinational organizations.

In November 1983, congressional concern over existing conditions, prompted the enactment of the International Lending Supervision Act of 1983 ("ILSA"). The Act directed that the federal banking agencies cause banking institutions to establish minimum capital levels for banking organizations. In December 1983, the Board, therefore, published the guidelines as Appendix A to the totally revised Regulation Y (12 C.F.R. section 225). Then in April 1985, the Board adopted new capital adequacy guidelines to increase the required minimum primary and total capital levels for the larger regional and multinational bank holding companies and state member banks. This action, when considered in conjunction with the capital maintenance regulations of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, established uniform minimum capital levels for all federally supervised bank holding companies, regardless of size, type of charter, primary supervisor or membership in the Federal Reserve System.

The strengthening of supervision over banks and bank holding companies is an equally imposing supervisory concern. The Federal Reserve System adopted a number of supervisory policies in 1985 that directly affected the supervision of bank holding companies, such as the increased frequency and scope of inspections and the communicating of the results of inspections (refer to Manual section 5000). In addition, the scope of the inspection was expanded to provide for a comprehensive analysis of man-

agement's ability to direct and control the organization utilizing the basic assumption that the bank holding company is responsible for the direction and vitality of the organization. Overseeing the supervision of banking organizations entails evaluating management's policies and procedures, wherever they are established within the corporate structure, as part of the examination/inspection process. Such policy areas include the consolidated planning process, risk management, funding, liquidity, lending, management information systems, loan review, and audit and internal controls.

The Board, concerned with strengthening the supervision over member banks and bank holding companies, adopted a policy statement regarding cash dividends not fully covered by earnings on November 14, 1985. The policy statement addressed the situation when cash dividends are not fully covered by earnings, which represents a return of a portion of an organization's capital (refer to Manual section 2020.0 for a discussion regarding the policy statement).

The Board adopted a policy statement on April 24, 1987, also related to the strengthening of the supervision over subsidiary banks of bank holding companies. The Board reaffirmed its long-standing policy that a bank holding company should act as a source of financial and managerial strength to its subsidiary financial institutions. The policy statement provides that a bank holding company should not withhold financial support from a subsidiary bank in a weakened or failing condition when the holding company is in a position to provide the support. The Board emphasized that a bank holding company's failure to provide assistance to a troubled or failing subsidiary bank under these circumstances would generally be viewed as an unsafe and unsound banking practice or a violation of the Board's Regulation Y (refer to section 225.4 (a)(1)) or both.

Congress limited the expansion of nonbank banks with the passage of the Competitive Equality Banking Act of 1987. The legislation redefined the definition of "bank" in the Bank Holding Company Act so that an FDIC-insured institution is a bank. Existing nonbank banks were grandfathered but certain limitations were imposed on their operations.

In an effort to further strengthen the capital position in banks and bank holding companies, the Board of Governors of the Federal Reserve System, on January 19, 1989, issued final guidelines to implement risk-based capital require-

ments for state member banks and bank holding companies. The guidelines are based on the framework adopted July 11, 1988, by the Basle Committee on Banking Regulations and Supervisory Practices, which includes supervisory authorities from 12 major industrial countries. The guidelines are designed to achieve certain important goals:

- Establishment of a uniform capital framework, applicable to all federally supervised banking organizations (the guidelines were also adopted by the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation);
- Encouragement of international banking organizations to strengthen their capital positions; and,
- Reduction of a source of competitive inequality arising from differences in supervisory requirements among nations.

The guidelines establish a systematic analytical framework that: (1) makes regulatory capital requirements more sensitive to differences in risk profiles among banking organizations; (2) factors off-balance sheet exposures into explicit account in assessing capital adequacy, minimizes disincentives to holding liquid, low-risk assets; and achieves greater consistency in the evaluation of the capital adequacy of major banking organizations throughout the world.

The risk-based capital guidelines include both a definition of capital and a framework for calculating weighted risk assets by assigning assets and off-balance sheet items to broad risk categories. An institution's risk-based capital is calculated by dividing its qualifying total capital (the numerator of the ratio) by its weighted risk assets (the denominator).

The guidelines provide for phasing in of risk-based capital standards through the end of 1992, at which time the standards become fully effective. At that time, banking organizations will be required to have capital equivalent to 8 percent of assets, weighted by risk.

Banking organizations must have at least 4 percent Tier 1 capital, which consists of core capital elements, including common stockholder's equity, retained earnings, and noncumulative and limited amounts of cumulative perpetual preferred stock, to weighted risk assets. The other half of required capital (Tier 2), can include, among other supplementary capital elements,

the non-Tier 1 portion of cumulative perpetual preferred stock, limited-life preferred stock and subordinated debt, and loan loss reserves up to certain limits.

The risk weights assigned to assets and credit equivalent amounts of off-balance sheet items are based primarily on credit risk. Other types of exposure, such as interest rate, liquidity, and funding risk, as well as asset quality problems, are not factored into the risk-based measure. Such risks will be taken into account in determining a final assessment of an organization's, capital adequacy, however.

Congress addressed the recent thrift crisis with the passage of thrift legislation, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which was signed into law on August 9, 1989. The legislation brought forth a number of important developments affecting bank holding companies. The legislation addressed:

1. acquisition of thrifts, in addition to failing ones;
2. conversion of thrifts to banks;
3. merger of thrifts with banks; and the
4. enhancement of enforcement authority.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) was signed into law on December 19, 1992. It was enacted to require the least-cost resolution of insured depository institutions, to improve supervision and examinations, to provide additional resources to the Bank Insurance Fund, and for other purposes. It required the federal banking agencies and their holding companies to prescribe standards for credit underwriting, loan documentation, as well as numerous other standards that are intended to preserve the safety and soundness of banking organizations.

FIDICIA further amended the International Banking Act of 1978. The Federal Reserve's authority over foreign bank operations (including representative offices in the U.S.) was significantly increased.

FIDICIA required the federal banking agencies to adopt standards for undercapitalized financial institutions. The Board, on September 18, 1992, issued Prompt Corrective Action Measures for state member banks.

During 1992, the Federal Reserve issued guidance on such issues as the monitoring and controlling of risk from asset concentrations, the disclosure, accounting, and reporting of past due (nonaccrual) loans, and the need for consistent methods in determining the amount of the allowance for loan and lease losses.



With the FIRREA and FIDICIA legislation, Congress re-emphasized the need for continued strengthening of the supervision over financial institutions. The strengthening of supervision over banks and bank holding companies will

continue to be a primary objective of the Federal Reserve. As it is now, it will be continuously emphasized during the examination/inspection of member banks and bank holding companies during the 1990's and beyond.

The Manual is presented in “sections” which have been grouped together into “parts” that have in common a central theme pertaining to BHC supervision. For example, Part II is composed of sections which discuss topics of special interest for supervisory review. Part III is composed of sections which discuss the various exemptive provisions to the nonbank prohibitions of the BHC Act. Part IV presents sections on the preparation of a financial analysis while Part V discusses the methods used to prepare the inspection report forms.

In preparing to conduct an inspection and complete the inspection report forms, the examiner should review the information requirements presented in Part V which include a “section” for each page within the inspection report. Many of these sections contain cross-references to other sections within Parts II–IV of the Manual that present in greater detail the issues to be considered during the inspection process. The examiner assigned to complete a particular inspection report page should review the sections cross-referenced in Part V.

Given that the overall objective of the Manual is to standardize and formalize inspection objectives and procedures that provide guidance to the examiner and enhance the supervisory process, the content of the sections within Parts II–IV are grouped into broad categories. They are:

1030.0.1 INSPECTION OBJECTIVES;  
INSPECTION PROCEDURES;  
LAWS, REGULATIONS,  
INTERPRETATIONS, AND ORDERS

Not all of the categories are presented in each section. Where a particular topic is exclusively financially related and does not involve legal considerations, the subsection on “Laws, Regulations, . . .” may be omitted.

These procedures were designed for a full-scope, comprehensive inspection. It is recog-

nized that in some instances the procedures may not apply in their entirety to all bank holding companies.

Examiners may exercise a measure of discretion depending upon the characteristics of the organization under inspection.

References to the “Examiner’s Comments” inspection report page throughout this Manual are synonymous with Core Page 1 of the inspection report—“Examiner’s Comments and Matters Requiring Special Board Attention”—as discussed in Part V of the Manual.

Part V of the Manual concerns the inspection program and report forms.

1030.0.2 NUMBERING SYSTEM

The Manual is arranged using a numerical coding system based on the Manual’s parts, sections and subsections. Parts are differentiated using “thousands” notations, sections using “digits” notations, and subsections using “tenths” placed after a decimal point as follows:

Part II—Topics for Supervisory Review	2000.0
Section 6—Management Information System	60.0
Subsection 1—Audit	.1
	<hr/> 2060.1

1030.0.3 ABBREVIATION

The Bank Holding Company Act of 1956, as amended, is abbreviated as “the Act” throughout the Manual.

1030.0.4 AMENDMENTS TO THE  
MANUAL

Amendments will be published periodically as needed.